Lesson 4 — The Law of Interest and The Law of Wages (a synopsis)

This lesson corresponds to Book III, Chaps. 3 to 8, In Progress and Poverty.

In establishing the law of rent, wages and interest were considered together. Now the focus narrows to study of the laws of interest and wages separately. The law of interest comes first because wages are the ultimate object of the course.

Review

Interest as used in political economy refers only to the return on capital — products that are expected to afford an income. It does not include the payment for the loan of money. Land, remember, is not capital because it was not produced. The payment for land is rent. Only in cases where stocks or bonds represent a claim on capital (products of labor) do their returns represent economic interest.

When people say that capital employs labor, they are referring to one group of people who hire another group of people. In reality, it is not tools and machinery that use people, but people that use tools, machinery, buildings, and products that are intended for sale. Therefore, in political economy it is labor that employs capital.

The quantity of capital may be increased by either producing more capital, or by redirecting existing wealth from consumption to production. The quantity of capital may be decreased by the wear and tear of buildings and machinery, a reduction in inventory, or by the transfer of existing wealth from production to consumption.

The Cause and the Law of Interest

Labor, with the use of capital, produces wealth. How is it determined what portion of any product goes to the workers (labor), and how much goes to the owners of the capital involved in producing it? In other words, why are people who borrow capital, expected and willing to pay back more than they borrowed?

The first thought is usually that capital increases the results of labor; therefore, interest is the reward for greater productivity. More dirt can be moved with a wheelbarrow than the bare hands. More firewood can be obtained with a saw. Next, an example is explored in which capital increases production, but the borrower is not willing to pay interest.

Suppose that James and William have equal skill and knowledge, but only James has a bow and arrows, the tangible results of two weeks labor. For one year James' offer to lend William the bow and arrows, which they both agree will last for 50 weeks. If William borrows the bow and arrows, he can hunt for the first 50 weeks and will have to take the two remaining weeks to make a new bow and arrows for return. Otherwise, James would not be getting back what he lent: a new bow and arrows.

Suppose James offer to lend the bow and arrows was conditioned upon not only getting back a new bow and arrows, which were borrowed, but some of the meat and fur as well. He might have said give me the difference between what you would likely have caught with stones you picked up on the way and what you do catch with the bow and arrows. The alternative is obvious. William would have made his own bow and arrows. He would have taken the first two weeks to made his own bow and arrows and used the remaining 50 weeks to hunt. Whether he takes the first two weeks to make a bow and arrows and hunts for the remaining 50 weeks, or he borrows a bow and arrows, hunts for the first 50 weeks, and takes the remaining two weeks to make a new bow and arrows, gives the exact same result: fifty weeks worth of meat and fur, and a worn out bow and arrows. (Full elaboration Progress and Poverty pg.177)

In this example, the use of capital produced a greater result — a result not possible without the use of capital. Yet, William was not willing to borrow the capital if he had to pay interest. Therefore, we must conclude that the cause of interest comes from something other than the increased productive power of capital. If all production were of the nature of bows and arrows, it is doubtful if interest would be asked for or paid except under special circumstances. However, some production is conceptually different; it is used to harness the productive and reproductive forces of nature.

Suppose you put away some freshly made wine. Does it get old and loose its value? Does it age and increase in value? What about seeds and animals; do they grow? Wine does not age until it is prepared; seeds do not grow until they are planted. By borrowing wine or seeds (capital), you can harness the reproductive forces of nature immediately, and by doing so, experience a larger total result at the end of the year. This, Henry George believed was the basic cause of interest.

There may be other causes of interest. If machines eliminate steps that are originally necessary, but never need repeating as long as the capital is maintained, than there is an advantage in the use of existing capital, and a willingness to pay interest for that advantage. Suppose that a modern steel mill is built. As long as it is maintained, there are many primitive steps like making the making the first iron and steel that will never have to be performed again. For that advantage people pay interest. Consider a recipe. Having once been typed, it can be photo copied and given to an infinite number of other people for pennies a piece. However, if all the copies are lost, someone will have to retype it before it can again continue to be produced for pennies a copy. Interest for the use of an existing copy would be payment for never having to type it ever. **Interest is a payment for the advantage of time, which stems from the use of existing capital.**

In the first mode of production, (adapting) the primary benefit of capital is in its use, and primarily enjoyed by the user. In the second mode of production (growing) the primary benefit of capital is in its increase, and enjoyed by the owner of the capital. Any labor involved in the process of affecting that increase must be paid out of that increase, and paid as much as they could have produced in the first mode of production, like carpentry. Any one who borrows capital for use in adapting, like carpentry, will have to pay as much as that capital would have increased in value were it maintained in a form capable of increase like seeds or wine.

The maximum return that can be obtained for the use of capital is the entire increase in the value of the capital. In the analysis of George, this resulted from the productive and reproductive forces of nature. That is to say: the difference between what the capital (a crop that grows) would have been worth when you borrowed it, and what it would have been worth when you returned it.

Since rabbits increase faster than horses, one might think that there would be a tendency to raise only rabbits. However, As more rabbits are bred, their supply goes up, and their value goes down (supply and demand); as fewer horses are bred, their value tends to go up. This compensates for the faster increase in the number of rabbits, and brings the return from capital toward a common level.

Sometimes capital yields an exceptional increase, like the value of wine from an extraordinary year for the grapes. Sometimes capital yields little or no increase, due to a blight or a drought. The greater the risk, the less competition, and the higher the returns. Therefore, in the long run, risk determines the different rates of interest. In the aggregate (total) risk is averaged, and interest tends to a common level.

The minimum return that can be obtained for the use of capital, is the return of capital. That is to say, a value equal to the one lent. Otherwise, there would be a penalty for lending capital.

People will borrow capital only if they gain more than they would have gotten had they first saved up their own capital and used it. Those who own capital will only lend it if they are paid more than they would have gained by keeping it, and enjoying the increase in its value.

The normal point of interest will tend to settle around that point which will make the rewards of labor and capital equally attractive. That is to say, will give an equal result to either for an equivalent effort or sacrifice made. (Full elaboration Progress and Poverty pg.195 - 199)

If the rate of interest tends to rise above the point of equilibrium with wages, workers will direct their labor to the production of capital, increasing the supply of capital and reducing the supply of labor available for the use of capital. This will increase wages and reduce interest.

If the rate of interest tends to fall below the point of equilibrium with wages, workers will direct their labor to the use of existing capital, consuming the supply of capital for loan, and creating a shortage. This will increase the rate of interest and bring wages and interest back into equilibrium

Suppose there was a shortage of sewing machines in relation to the availability of dressmakers: Interest for the use of sewing machines would rise; more sewing machines would be produced and offered for loan; and this would continue until there were more sewing machines than dressmakers.

Suppose there was a shortage of dressmakers in relation to sewing machines: Wages would go up and more people would become dressmakers. This would continue until there were more dressmakers than sewing machines.

Although there is no longer free land available today, the free land relationship of capitalists to landowners that existed in the 18th and 19th centuries will be explored first before analyzing the distribution of interest under the present circumstances.

The general rate of interest will be proportional to the total value resulting from the advantage of time in the use of existing capital where the land is free. This is also the least productive land in use, since no particular land would be used while superior land was free.

When there is a greater advantage of time on superior land, that greater value resulting from the use of existing capital is taken as rent.

"I have endeavored at this length to trace out and illustrate the law of interest more in deference to the existing terminology and modes of thought than from the real necessities of our inquiry. . . In truth, the primary division of wealth in distribution is dual, not tripartite. Capital is but a form of labor, and its distinction from labor is in reality but a subdivision of labor, just as. . . skilled and unskilled would be. . . .we have reached the same point as would have been attained had we simply treated capital as a form of labor, and sought the law which divides the produce between . . . natural substances and powers, and human exertion—which. . . by their union produce all wealth." Henry George

The Law of Wages

In a complex society there are great differences in wages. They are attributed to different skills and abilities, the expense of learning them, and the agreeableness or disagreeableness of occupations. These characteristics act through supply and demand to determine individual rates of wages.

When free land presents a natural opportunity in farming, timber or mining, it sets the standard for wages in manufacturing and commerce, which are conducted on superior land that is fully owned. No one will work for an employer unless she is paid more than she could produce working for her self where the land (opportunity) is free.

To reiterate: where land is free the entire product goes to the producers. (Labor and capital) When rent arises, ***"Wages are determined by what labor can produce on the best land that is free."*** This is the law of wages.

If all natural opportunities were reduced to ownership (there were no free land), wages and interest would fall to a bare minimum. It would fall to an amount below which productivity would also fall. Without free land, wages would fall to an amount below which the least productive workers would be hungry and weak, the skilled workers would loose the incentive to learn their skills and accumulate knowledge, and the incentive to lend capital would be lost. This will be fully elaborated in the next lesson.

Although wages and interest may go up or down as an amount, they may at the same time go down or up in proportion to rent. That is to say: become a smaller or larger portion of the entire product.

Correlation of the Laws of Distribution

There are two axioms upon which all economic reasoning is based: "That people seek to satisfy their desires with the least exertion", and "People's desires are unlimited". These are self-evident truths that are never questioned until stated. We may desire fresh air and exercise, so we take the long way home through the park, but that was our desire, rather then getting home faster with less steps. We may want to help others, or accumulate more knowledge. We may even want to consume less food, but there is always something else we want. It is, therefore, with great confidence that we apply these axioms to the laws of distribution.

Wages, interest and rent are determined by the margin of production, and account for the full division of the product. Taxes and other confiscations will be analyzed later.

In summary: "The law of wages accords with and explains universal facts that without its comprehension seem unrelated and contradictory. It shows that: Where land is free and labor is unassisted by capital, the whole produce will go to labor as wages. Where land is free and labor is assisted by capital, wages will consist of the whole produce, less that part necessary to induce the storing up of labor as capital. Where land is subject to ownership and rent arises, wages will be fixed by what labor could secure from the highest natural opportunities open to it without the payment of rent.

"Where natural opportunities are all monopolized, wages may be forced by the competition among laborers to the minimum at which [the least productive] laborers will consent to reproduce." Henry George