Postscript: Elevating Usury to Respectability

Calvinists only tolerated usury. Retail lending was, however, restored to some measure of respectability only with the Enlightenment and the rise of economic liberalism. We will examine liberalism in Chapter 4. It may be useful though to complete our discussion of attitudes towards lending here. Interestingly, the patron philosopher of economic liberalism, Adam Smith, was in favor of free markets everywhere, except when it came to finance.

Smith, unlike Aristotle, felt the case for charging interest was clear, writing “[A]s something can everywhere be made by the use of money, something ought everywhere to be paid for the use of it”. It was therefore surprising that Smith advocated a legal interest rate ceiling instead of allowing the loan market to be free. He wrote,

“The legal rate... ought not to be much above the lowest market rate. If the legal rate of interest in Great Britain, for example, was fixed so high as eight or ten per cent, the greater part of the money which was to be lent, would be lent to prodigals and projectors, who alone would be willing to give this high interest. Sober people, who will give for the use of money no more than a part of what they are likely to make by the use of it, would not venture into the competition.”

Smith thus did not argue for a ceiling on moral grounds but on economic grounds. Essentially, he claimed that at high interest rates, only prodigals (such as a spendthrift son) and projectors (with wild and risky schemes) who had little intent or prospect of repayment would borrow, while sensible businessmen who intended to undertake safe projects with moderate returns would not. Interest rate ceilings were necessary to keep the loan market from being cornered by wastrels or the risky.

It was left to Jeremy Bentham to argue for freeing even finance. Bentham, a contemporary of Adam Smith’s, is best known for championing utilitarianism, which posits that policies that ensure the greatest happiness of the greatest number should be adopted. In 1787, he wrote a series of letters from the estates of Russian Count Potemkin in Belarus entitled In Defense of Usury, making the case for the futility of limits on interest rates, and the importance of a fully free market. In a sense, he extended what was advocated in much of the Wealth of Nations to finance.

Arguing that the interest rate is a price for money, Bentham did not see why the price of money should be limited, when the price of other goods is generally not limited or fixed. He saw no difference between “a man who takes as much as he can get...for the use of a sum of money” and the man who bought “a house with it, and made a proportional profit by the house”. Moreover if the interest rate was not to be determined by the forces of supply and demand in the market, how would it be set?

As to Smith’s worry about prodigals, Bentham argued that they have assets to dissipate. Even if interest rates were capped, they would be able to borrow using the assets as security and still find ways to run down their inheritance. The only way to protect prodigals against themselves would be to prevent them from selling or borrowing against their assets. Turning to “projectors”, Bentham argued that innovation is the fount of economic growth. Routine investment – the sober Calvinist investor Adam Smith espoused – cannot do much for enhancing the standard of living, but it is the projector who has allowed
mankind to advance “from that state in which acorns were their food, and raw hides their clothing, to
the state in which it stands at present”. In emphasizing the role of innovators in economic growth,
Bentham foreshadowed modern economic theory, which sees new ideas and technologies of production
rather than more capital investment or employment as the source of sustained long-term growth.

Turning to other arguments that were often made for prohibiting usury, Bentham distinguished
between simpletons and the poor. Simpletons may not be capable of making rational decisions, but this
was no different for borrowing as for the purchase of goods. Why protect them only on the former?
Turning to the protection of the poor, Bentham argued that the poor are smart enough to understand
where their interests lie. If they are willing to borrow at a high rate, it must mean that they still find
borrowing of value. How would a legislator know better where to set rates? Moreover, if legitimate
lenders cannot charge high rates to the poor, they would cease lending. Usury laws would then force
desperate poor borrowers into the hands of shadowy lenders, who would be able to charge yet higher
rates because of the illegality of the transaction.

Defense of Usury was immediately and enormously influential in Europe and the United States, though
aspects of Smith’s views have been rescued by modern economists. For instance, the Nobel prize-
winning economist Joseph Stiglitz, together with Andrew Weiss, has argued that higher interest rates
would indeed attract a disproportionate amount of projectors with risky projects (for they would expect
to fail most of the time and pay the high interest rate only if wildly successful). This may make charging a
high interest rate unprofitable. Of course, these are arguments for why a lender might prefer to cap the
interest rate it charges voluntarily, rather than an argument for a usury ceiling imposed by government.

Clearly, Bentham’s arguments took hold so quickly because Western society was readier for them. With
the dawn of the industrial revolution, “projectors” like James Watt and Matthew Boulton, who
developed the steam engine, were everywhere. With a variety of new profitable opportunities looking
for financing, market interest rates would naturally be higher, hence the pressure to do away with usury
ceilings. Indeed, Bentham himself was a kind of “projector”, looking to sell his idea of a prison building
called Panopticon, suitable also for any other population that required to be monitored constantly,
including school children.

Equally important, Bentham recognized the practical difficulties of enforcing usury laws in the more
rational Age of Enlightenment that could no longer rely on the fear of an all-seeing God and a settling-up
of sins in after life to guide commercial behavior. Usury ceilings were always difficult to enforce, but
without self-policing, enforcement was much harder – high interest rates could always be disguised as
processing fees, as many a modern borrower discovers. Hence, Bentham’s argument that far from
protecting the poor against the extreme bargaining power of the lender, the usury ceiling would likely
drive them into the hands of the utterly unscrupulous moneylender made sense. Nevertheless, because
of the difficulty of justifying loan sharking to the public, most countries still impose interest rate ceilings.
XXX Using a different copy to you I believe. In which case, the quotation above might need to be adapted to just: “as something” instead of its current form.


XXX General notes:
1. Some footnotes missing in text. (Ex. 43)