

Adam Smith on Usury Laws

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- *From:* "ruetheday@xxxxxxxxxxx" <ruetheday@xxxxxxxxxxx>
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It's truly amazing how something written well over 200 years ago could be so timely and relevant to what we are seeing today with the collapse of the subprime mortgage market and its potential negative impact on the entire housing market and the entire economy.

This is from Book II Chapter IV of The Wealth of Nations:

In countries where interest is permitted, the law, in order to prevent the extortion of usury, generally fixes the highest rate which can be taken without incurring a penalty. This rate ought always to be somewhat above the lowest market price, or the price which is commonly paid for the use of money by those who can give the most undoubted security. If this legal rate should be fixed below the lowest market rate, the effects of this fixation must be nearly the same as those of a total prohibition of interest. The creditor will not lend his money for less than the use of it is worth, and the debtor must pay him for the risk which he runs by accepting the full value of that use. If it is fixed precisely at the lowest market price, it ruins with honest people, who respect the laws of their country, the credit of all those who cannot give the very best security, and obliges them to have recourse to exorbitant usurers. In a country, such as Great Britain, where money is lent to government at three per cent. and to private people upon a good security at four and four and a half, the present legal rate, five per cent, is perhaps as proper as any.

The legal rate, it is to be observed, though it ought to be somewhat above, 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. A great part of the capital of the country would thus be kept out of the hands which were most likely to make a profitable and advantageous use of it, and thrown into those which were most likely to waste and destroy it. Where the legal rate of interest, on the contrary, is fixed but a

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very little above the lowest market rate, sober people are universally preferred, as borrowers, to prodigals and projectors. The person who lends money gets nearly as much interest from the former as he dares to take from the latter, and his money is much safer in the hands of the one set of people than in those of the other. A great part of the capital of the country is thus thrown into the hands in which it is most likely to be employed with advantage.

In short, Smith supported usury laws that capped the maximum rate of interest that could be charged on a loan. His rationale was simple, straightforward, and impeccable – if you allow lenders to charge any interest rate they want, loans will be steered to those most likely to waste and squander the money and the effects are likely to be disastrous for the lender, the borrower, and the economy; if you cap it at a rate a little above the lowest market rate, loans will be steered to those most likely to invest the money productively.