Does Low interest really help?

Interest Rates, Housing, and Social Security
By Mike Curtis

The majority of Americans owe more money in mortgages on their homes and car loans than they have in interest baring investments like bonds, money markets, and savings accounts. Therefore, low interest rates and inflation seem to work in their favor — especially with fixed rate mortgages.

Low interest rates enable us to buy a much more expensive house or car than we could afford at a higher rate of interest. Inflation, even a small amount each year, cancels debt in a significant way over the life of a 30 year mortgage. And it does it without in any way diminishing the value of the asset that was purchased. Hallelujah!

But, who does it actually benefit? When it comes to a 30 year fixed rate mortgage on a home, the low interest rate certainly does allow the buyer to acquire the building, which is usually more than half the value of residential real-estate, for significantly lower payments, and inflation cancels the debt without diminishing the value of the building (the building is worth more dollars, but the payments stay the same).

The Value of Buildings

Both of these consequences result from the fact that the value of buildings is relative to the cost of re-production. A building generally tends to be worth what it would cost to build another one like it, minus any wear and tear.

Land Value

The value of land on which a building sits, is very different. Because it can't be reproduced, its rental value is simply the most that anyone is willing to pay for its exclusive possession. The income from land is the total income from the site (land and buildings) — minus all the expenses associated with providing the buildings and other improvements. That would include interest (the return to the building), maintenance, management, depreciation, taxes, fees, and all the other expenses.

purchase value

The purchase value of any parcel of land is always set by the person who is willing to pay the most, and he is the one with the largest expectation of future income and the money to out bid all others.

Does Low interest really help?

The person who wants to buy a parcel of land, starts their calculations by estimating the size and type of buildings and other improvements that will yield the most income in addition to the cost of providing the buildings and other improvements. It is this potential Income from the land that is capitalized into a purchase value.

Capitalization is a method of equating land and other things that have an income, but can't be reproduced, to capital, which has an income and can be reproduced. If capital yields 5% interest, a parcel of land yielding an income of $100 will exchange for $2,000 worth of capital because it will yield the same $100 income.

Speculative component

In addition to a capitalization of the potential income, a prospective buyer of land adds a speculative component based on expected increases in the income. That means the income from land is almost always less than the purchase price multiplied times the current rate of interest at the time of sale. There are exceptions; sometimes the speculative component is eliminated when land prices are falling during a severe recession, or in a slum where conditions are steadily getting worse.

Does Low interest really help?

The speculative component in the selling value of land is not due to the effects of low interest rates, but it is the most important factor in the problem of home ownership. If a speculative component wasn't part of the purchase price (value) of land, the difference in the total outlay between renting and buying a house and lot would be how fast you were required to pay off the principle. It is the biggest factor in preventing renters from becoming buyers.

Low Interest & the Value of land.
The lower the rate of return on capital, the less it yields, but the more capital is required to maintain a given income. So, the lower the rate of interest, the higher the purchase price of land. The land buyer receives no benefit from lower interest rates, because the lower interest payments are counteracted by the higher purchase value.

Now it gets even more complicated. The frontier of the 19th century is long gone. There is no longer a Free-land alternative. The income from land is the sum total of all the benefits, minus the detriments. The less it costs to finance the purchase of a building, the more the land it sits on is worth. You can't enjoy the building without a parcel of land to park it on. So, the cheaper the building, the more valuable the land it sits on. Since all buildings are not financed, the lower interest rate would not affect all transactions, but as long as the vast majority of buildings are purchased with a mortgage, a lower interest rate will tend to make the land commensurately more valuable. Therefore, while there is a net benefit from low interest rates in the financed purchase of a vehicle or a house to be put on land you already own, the benefit of low interest rates in the purchase of a house and the land it sits on together is off-set by the higher price of the land. Again, there is no net benefit to the buyer.

In the two cases where low interest rates would make a difference in the lives of people without any collateral: student loans and credit cards, the interest rates are ten and twenty times what the government is paying this year to borrow money when it issues Treasury Bills.

Now, turning to Social Security and its Trust Fund. The age at which people can collect social security has steadily risen as a larger percentage of workers are collecting benefits as opposed making contributions.

Does Low interest really help?

Part of the benefits received have been from accumulated contributions, some have come from those who paid in but didn't live long enough to collect, and some have been transferred from younger workers paying in to those collecting.

The fact that the average recipient is living and collecting longer is part of the equation, but the fact that the ratio between recipients and contributors is increasing is believed to be the biggest factor in the need to raise the age at which people can collect Social Security.

However, one thing is obvious, if Social Security were funded by each workers own contributions the low interest rates that help landowners (and no one else) would be the biggest reason why they are raising the retirement age for full benefits.

Let's take a person who earned the Minimum Wage their entire adult life — currently $7.25 per hour (just over $15,000 per year). Let's assume they worked 40 hours per week 52 weeks a year for 45 years and they retired at the end of 2014. Under the system as it is and has been, they and their employer's contribution (at the current rate of withholding

12.4%), plus the interest that would have been paid to the account (if it wasn't being paid out to current recipients) would have been approximately $100,000. Of that, 72% ($72,000) goes for pensions (28% goes for disabilities and other things).

The government has paid different rates of interest over the last 45 years, and inflation has diminished those rates in varying degrees. The government is now paying 2% interest on the money borrowed from the Social Security Trust Fund and there is no inflation at the present time. The average length of time a person now collects Social Security is 21 years.

So, assuming the government continued to pay 2% interest, in order for the Minimum Wage worker's account to last the full 21 years of life after age 65, he would only get a payment of $332 a month.

Now, What would our Minimum Wage worker receive today with the same 12.4% of earnings contributed if the government had paid 4.9% interest with no inflation for the last 45 years? Instead of $100,000 he would now have accumulated over $226,000 and with 72% of it he would continue to receive in retirement the same $15,000 per year ($1,250 per Month) he was earning when he worked, and he would receive it for the rest of his life.

So, while low interest rates only help landowners, low interest rates require people to work longer and longer, and diminish Social Security benefits for all.

In Progress & Poverty written in 1879, Henry George points to statistics showing that wages and interest have risen and fallen conjointly, and he gives a theoretical explanation that stems from the fact that capital (buildings, machinery, and products in the course of being made) is produced by labor. In more recent times this is not as obvious, because of inflation. The devaluation of money off sets the nominal rate of interest. None-the-less, in 2015, a period with no inflation, risk free government bonds pay just one half of one percent interest. At the same time, wages have not recovered their pre-recession buying power. Wages and interest generally continue to rise and fall together in spite of the fact that the supply of money, and therefore, rate of interest, is artificially adjusted.

The Single Tax

Does Low interest really help?

The ultimate cause of low wages and interest is the hoarding of land — holding it in an unused and under used condition. This eliminates the free-land opportunity that sets the rates of wages and interest throughout the economy, and drives them to an amount below which productivity would fall. Interventions like the Legal Minimum Wage do ameliorate this, but only to a limited degree. By taxing the rental value of land for public purpose, it would alter the incentive. People would hold as little land as possible and produce as much as possible on it. This would free up an enormous area of the less productive land, making it freely available to all. All who were willing and able to work would find employment, and wages and interest everywhere would rise to the full value that labor and capital could produce where the land was free. The greater productivity that results from superior land would go finance the infrastructure and all expenses of government.