Restricting consumer credit access: Household survey evidence on effects around the Oregon rate cap

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Abstract

Many policymakers and some theories hold that restricting access to expensive credit helps consumers by preventing overborrowing. I examine some effects of restricting access, using household panel survey data on payday loan users collected around the introduction of binding restrictions on payday loan terms in Oregon. Borrowing fell in Oregon relative to Washington, with former payday borrowers shifting partially into plausibly inferior substitutes: bank overdrafts and late bill payment. Additional evidence suggests that restricting access caused deterioration in the overall financial condition of Oregon households. Overall the results are consistent with restricted access harming, not helping, consumers on average.

1. Introduction

Expanding access to credit is a key ingredient of financial development strategies worldwide. The Small Business Administration and comparable small and medium-enterprise (SME) initiatives target billions of dollars of commercial credit in developed economies. The microcredit industry targets billions of dollars of commercial credit in developing economies. A widely shared presumption of these efforts is that expanding access to “productive” credit makes entrepreneurs and small business owners (weakly) better off.

There is less consensus on whether access to consumer credit does borrowers more good than harm. Market forces have spurred dramatic growth in subprime nonmortgage consumer credit in the US; as others have noted, there are now more outlets offering small, two-week “payday loans” at 400% APR than McDonald’s and Starbucks outlets combined.1 Revealed preference logic says that this growth should be welfare-improving: a consumer borrows only if she will benefit (weakly, in expectation). In contrast a growing body of work on psychological biases in household finance suggests that many consumers overborrow relative to an unbiased benchmark.2 This work can motivate restricting access.

Indeed, policymakers often raise concerns about “unproductive” lending at “usurious” rates in subprime markets. Usury laws have existed for millennia.3 At least 13 states currently have binding restrictions on payday loan terms. New Hampshire and Ohio enacted

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1 Payday loans typically extend a few hundred dollars in return for a check postdated to the borrower’s next pay date in the amount of the loan principal + a finance charge of at least $15 per $100. See Section 2 for details on the product and the market.

2 One psychological bias that can produce overborrowing is present-biased (time-inconsistent) preferences; see, e.g., Laibson’s (1997) model and contrast to the neoclassical (exponential discounting) case where revealed preference reveals the consumer’s welfare-maximizing choice. Empirically, Skiba and Tobacman (2008b) find that payday borrowing patterns are most consistent with partially naïve quasi-hyperbolic discounting, and Laibson et al. (forthcoming) find that consumers with present-biased preferences would commit $2000 to not borrow on credit cards. Other explanations for overborrowing include biased expectations (see, e.g., Ausubel (1991) on over-optimism producing excess credit card borrowing), and exponential growth bias that produces underestimation of borrowing costs (Stango and Zinman, 2009, forthcoming).

3 Price ceilings can benefit borrowers and improve efficiency even in the absence of behavioral biases, if insurance markets are incomplete and ceilings do not produce credit rationing that is too severe (Glaeser and Scheinkman, 1998).
their restrictions in 2008, and several more states are considering legislation that would restrict access in this $40 billion market. A 36% APR federal interest rate cap on loans to military households took effect in 2007, and President Barack Obama seeks to “Cap Outlandish Interest Rates on Payday Loans” by extending that cap to all Americans.4

A growing empirical literature on the effects of access to expensive credit on borrowers has added fuel to this debate. Several studies find that access to expensive credit exacerbates financial distress (Campbell et al., 2008; Carrell and Zinman, 2008; Skiba and Tobacman, 2008a; Melzer, 2009). These findings suggest that psychological biases lead consumers to do themselves more harm than good when handling expensive liquidity, and hence that restricting access will help consumers by preventing overborrowing. But several other studies suggest otherwise. They find that, on average, access to expensive consumer loans helps borrowers make productive investments, broadly defined: smoothing negative expenditure shocks (Wilson et al., 2008; Morse, 2009), preventing negative income shocks (Karlan and Zinman, forthcoming), or otherwise managing liquidity to alleviate financial distress (Morgan and Strain, 2008).5 These findings suggest that restricting access will harm borrowers by preventing them from financing valuable consumption smoothing and investment opportunities (e.g., in job retention).6

I add to this literature by examining the effects of restricting access to expensive consumer credit, using household survey data collected around new binding restrictions imposed by the state of Oregon in 2007 (the “Cap”, below).7 The neighboring state of Washington considered enacting similar restrictions but did not. Before- and after-Cap panel data, on a sample of Oregon and Washington respondents who were payday borrowers before-Cap, allow for difference-in-differences (DD) estimates of the effects of the Cap (and of access to expensive credit more generally) on borrower choices and outcomes.

The data provide two key advantages over comparable studies on the effects of access to subprime credit in the US. First, it measures usage of several different types of expensive loan products, permitting analysis of substitution (or complementarity) between payday loans and other liabilities. Second, it permits construction of a summary measure of financial condition based on a combination of an objective measure (employment status), and two subjective respondent assessments of their financial condition over the last 6 months, and of their expected trend for the future.8 Employ

4 http://www.barackobama.com/issues/economy/.

5 Other related studies in developing country settings focus on the effects of access to “productive” credit (targeted to microentrepreneurs) rather than consumer credit; see, e.g., Coleman (1999), Kaboski and Townsend (2005), McKernan (2002), Pitt et al. (2003), and Pitt and Khandker (2004). There may be little economic distinction between small, closely-held businesses and the households that run them, and there is evidence that microentrepreneurial loans are often used for income smoothing or household investment rather than business investment (Morduch 1998; Menon, 2003; Karlan and Zinman, 2009). See also Burgess and Pande (2005) and Burgess et al. (2005), which find that state-led bank branch expansion increased lending to the poor and reduced rural poverty in India.

6 Karlan and Zinman (forthcoming) find that access to a four-month loan at 200% APR significantly increased the likelihood that a borrower was employed 6–12 months after taking a loan. The mechanism seems to be that many borrowers use the loans to smooth shocks (to household health, or especially to transportation) that would otherwise lead to absences from work and eventual firing.

7 The data collection was funded by Consumer Credit Research Foundation (CCRF). CCRF is a non-profit organization, funded by payday lenders, with the mission of funding objective research. CCRF did not exercise any editorial control over this paper.

8 The survey questions are: “In general, how would you describe your financial situation in the last 6 months?” [getting better/getting worse/the same], and “Thinking about the future, do you expect your financial situation to:” [get better/get worse/stay the same]. Karlan and Zinman (forthcoming) find that treatment-on-the-treated effects.

9 e.g., To evaluate the optimality of a consumer borrowing decision given the possibility of psychological biases, in principle one would need complete data on that consumer’s preferences, expectations, cost perceptions, problem-solving approach, budget and liquidity constraints, and opportunity set.

10 The impact studies cited above also find evidence consistent with large treatment-on-the-treated effects.
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