

RESEARCH SUMMARY

Adverse Consequences of the Binding Constitutional Interest Rate Cap in the State of Arkansas

Many Americans today live paycheck to paycheck and use credit to pay unexpected bills or to cover normal bills in the event of an unplanned income disruption. The availability of consumer credit is limited and shaped through ongoing legislative and regulatory action. Interest rate caps are a common way states regulate credit markets. In Arkansas, there is a constitutionally imposed interest rate cap of 17 percent for all loans.

In “Adverse Consequences of the Binding Constitutional Interest Rate Cap in the Stake of Arkansas,” Onyumbé Ben Lukongo and Thomas W. Miller Jr. estimate that Arkansas’s binding 17 percent interest rate cap imposes a substantial cost on the state’s residents, who drive to neighboring states to take out small-dollar installment loans. Using zip code-level data on traditional installment loans from the American Financial Services Association (AFSA), their study develops a model to document differences in cash installment loan usage within Arkansas and between Arkansas and its six bordering states. The absence of installment lenders in Arkansas suggests that lenders cannot profitably engage in installment lending there. Dramatically increasing the allowable rate, or even removing the cap, would allow competitive market forces to allocate small-dollar loans to Arkansas residents who have a demand for the product.

Background

An important category of consumer loans covered by this interest rate cap are traditional cash installment loans from finance companies. This industry was created a century ago as a free-market alternative to the illegal lenders who flourished at the time. Progressive consumer advocates and capitalist nonbank lenders collaborated to draft the Uniform Small Loan Law of 1916, which was to serve as model legislation for the states. The model law enables lending at profitable rates, thus ensuring access to legal credit for borrowers in need. Borrowers can use the proceeds from a cash installment loan in any manner they wish. The borrower makes a series of equally sized payments. After the last payment, the borrower has paid off the loan.

Key Findings

The in-state shortage of installment loans is extreme in Arkansas, which has a constitutional 17 percent interest rate cap. Thus, although not technically banned from operating in Arkansas, traditional installment lenders do not operate in the state.

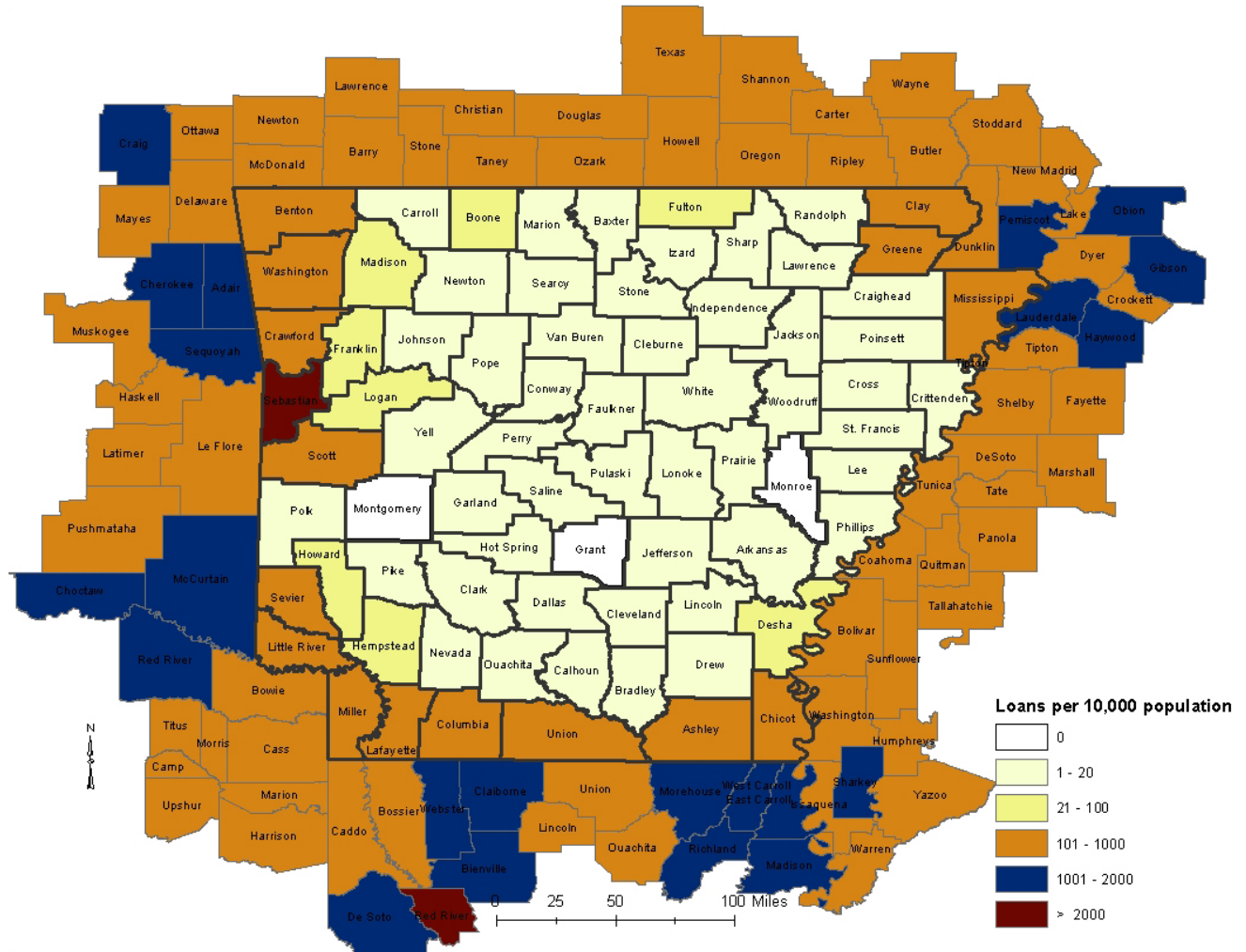
Traditional installment loan operations exist in each of the six states that border Arkansas. These states have either a higher interest rate cap than Arkansas or no interest rate cap. Consequently, Arkansas provides a natural experiment to examine the effects of the interest rate cap.

The study reveals the following key findings:

- *An installment loan “credit desert” exists in the interior counties of Arkansas.* Of the 26,654 installment loans in the dataset that are outstanding in Arkansas, 96.7 percent were held by Arkansas residents who live in counties adjacent to one of the six bordering states. Despite comprising about 55 percent of the state’s population, residents of interior counties held just 3 percent of the outstanding installment loans.
- *Arkansas residents willingly drive out of state to acquire installment loans that carry annual percentage rates (APRs) well in excess of 17 percent.* On average, Arkansas residents pay an APR of 80 percent for loans, with an average loan size of \$1,051. After adjusting for travel costs to obtain the loan from a neighboring state, Arkansas residents pay an average rate of about 93 percent. This finding is consistent with economic theory, which predicts that an interest rate cap would give rise to increased search costs.
- *Driving distance matters.* The study’s findings suggest a decline in the loan usage rate as the relative distance to out-of-state installment lenders increases. For distances beyond 40 to 45 miles, loan usage is very low. This is consistent with the idea that consumers weigh the costs and benefits of driving out of state to obtain an installment loan.
- *Lower rates of installment loan usage in Arkansas compared to its bordering states suggests unmet installment loan demand in Arkansas, particularly in the interior counties.* Overall, Arkansas residents hold installment loans at an average rate of 90.4 loans per 10,000 population, compared to 524.5 loans per 10,000 population in the border counties of states neighboring Arkansas. Residents of Arkansas’s interior counties held installment loans at a rate of only 5.5 loans per 10,000 population. This suggests unmet demand is also consistent with economic theory, which predicts an interest rate cap destroys gains from trade that would have occurred without a cap.

The following map is a visual depiction of the installment loan “credit desert” that exists in many of the interior counties of Arkansas.

Number of Traditional Installment Loans (in Sample) per 10,000 Population, Arkansas and Border Counties, September 2013



Source: Author generated map using ARC-GIS software and data provided by the American Financial Services Association (AFSA).