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RESEARCH SUMMARY

The Case against New Restrictions on Payday Lending

In the wake of the financial crisis, Congress and federal regulators moved aggressively to impose new regulations on a variety of consumer credit products, and they are considering new regulations on nontraditional lending products such as payday lending.

Todd J. Zywicki, George Mason University Foundation Professor of Law and executive director of the Law and Economics Center at George Mason University School of Law, examines regulations on the payday lending industry in "The Case against New Restrictions on Payday Lending." He finds that economic theory and empirical evidence strongly suggest that these regulations would stifle competition, force consumers to choose more expensive alternatives, and do little to protect consumers from overindebtedness and high-cost lending.

Regulators have long expressed concern about the apparently high cost of short-term, small loans and have tried to regulate their terms as well as those of other forms of consumer credit. As a result, much is known about the effect of regulation on borrowers and consumer lending markets.

KEY TAKEAWAYS

Economic research strongly supports two basic conclusions about payday lending.

Those Who Use Payday Lending Do So Because They Have Limited Alternatives

- Payday lending is used to deal with short-term exigencies, and a lack of access to payday loans would likely cause substantial cost and personal difficulty, such as bounced checks, disconnected utilities, or lack of funds for emergencies such as medical expenses or car repairs.
- Those who use payday loans have limited alternative sources of credit, and these include pawnshops, bank overdraft protection, credit card cash advances (where available), and informal lenders. Payday loans are less expensive than these alternatives.

Efforts to Regulate the Terms of Small Consumer Loans Almost Invariably Produce Negative Unintended Consequences That Vastly Exceed Any Social Benefits Gained from the Legislation

- Regulation that deprives consumers of access to payday loans would likely force many of them to turn to even more expensive lenders or to do without emergency funds.
- Although payday loans may enmesh some consumers in a "debt trap," so might the alternative sources of credit available to these borrowers. Moreover, evidence indicates that those who are led into a debt trap by payday lending are far fewer in number than those who benefit from access to payday loans.

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- Prior studies of price caps on lending have found that low-income and minority borrowers are most negatively affected by the regulations and the adjustments that they produce. Volumes of economic theory and empirical analysis indicate that further restrictions on payday lending would likely prove counterproductive and harmful to the very people such restrictions would be intended to help.

PRINCIPAL UNINTENDED CONSEQUENCES OF USURY REGULATIONS

- *Term re-pricing.* Lenders may offset interest rate limits by increasing the price of other terms of the loans or of related products. (Because payday loans are relatively simple products with few terms, term re-pricing is less common for payday loans.)
- *Product substitution.* If regulations make a certain product economically infeasible, lenders will be forced to offer other products that are not as attractive.
- *Credit rationing.* The restriction of credit might force borrowers to turn to less desirable alternatives, such as the informal sector of illegal loan sharks, or to do without credit altogether. Depriving consumers of access to credit could cause substantial economic and personal harm if it forces them to do without the funds for necessities such as medical care, car repairs, living expenses, rent, or work-related expenses such as transportation or work-related clothing.

The overall effect of usury regulations is to force lenders and borrowers to change the terms, types, and amounts of consumer credit compared to what they would agree to under a voluntary contract. Economists have almost uniformly concluded that forcing these changes in lending and borrowing behavior is harmful to small consumer loan borrowers.

CONCLUSION

Overall, economic theory, empirical evidence, and surveys of payday-loan customers all suggest that payday lending serves a beneficial role for many consumers by providing short-term emergency credit at lower cost and less inconvenience than available alternatives. While some users of payday loans may end up in a debt trap, those who do are not necessarily helped by restricting these loans, and eliminating payday lending would probably hurt many more people than it would help.

Eliminating payday lending would force many consumers to shift to less preferred (and more expensive) forms of borrowing, such as overdraft protection, pawnshops, Internet payday loans, or worse. Others would find themselves without credit, resulting in bounced checks and an inability to make necessary payments. Given the limited choices available to needy consumers to meet short-term borrowing exigencies, it is unlikely that further restricting their limited options will improve their situation.