

CHAPTER 13

Examining Arguments Made by Interest Rate Cap Advocates

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The lending of money is one of the world's oldest professions, which probably accounts for the recurring skepticism about its value.

—Irving Michelman¹

Personal credit use, and its price, has been a controversial societal topic—likely since the dawn of recorded history. Theologians, historians, politicians, economists, and others have offered disparate views. At the center of this topic are the questions of whether individuals should use personal credit and—if they do—what the “appropriate” price, or interest rate, is. The focus of this chapter is on the second question as applied to two widely used small-dollar loan products today.

Every day, consumers make choices based on the price of money—just as they respond to prices of other goods and services. Despite teeth-gnashing and

hand-wringing by philosophers, advocates, reformers, legislators, and others, the market for credit is not “special” or “different.” Simply stated, the market for credit obeys the laws of supply and demand.

Through the ages, monarchs, governments, and organized religions have made many attempts to influence this market, often through usury laws that set a maximum rate of interest. Homer and Sylla, however, detail how difficult it is for lawmakers to eliminate the concept of interest.² Systems will arise to create promises to pay more in the future than the money received today. Some market participants could find that the maximum interest rate is too low, so they create a loan contract at their preferred rate. In such a case, these market participants will either ignore the law or add clever elements to the deal to stay within the letter of the law.

As does any binding price ceiling, an interest rate cap interferes with the gains from trade flowing to both borrowers and lenders. This chapter discusses the effects of interest rate caps on borrowers and lenders. We begin the chapter with a brief discussion of the history of interest rate caps, which is followed by a description of the economics of price ceilings, particularly interest rate caps.

We then present a discussion of research addressing the arguments advocates of interest rate caps make to justify these caps. In that section, we show that rigorous academic research does not support any of these common arguments. We then discuss how consumer advocates and capitalists in the early twentieth century created the installment loan business designed to out-compete illegal loan sharks.

Following that section, we briefly discuss how the interest rate regulatory environment evolved in the traditional installment loan business, and we present discussions on the current state-based regulatory environment for two popular small-dollar credit products: traditional installment loans and payday loans. We then outline a path going forward that will benefit borrowers and lenders in the small-dollar loan market.

A BRIEF HISTORY OF INTEREST RATE CAPS

Interest rate caps, in the form of usury laws, likely represent the longest, and most repeated, government intervention in financial markets.³ The earliest

advocates of usury laws favored an interest rate of zero. Aristotle asserted that money was sterile and should earn no interest. Governments dating from ancient Egypt through the modern day have imposed interest rate ceilings for a variety of reasons.⁴

Glaeser and Scheinkman state that usury laws play many roles throughout history and seek to explain why interest rate caps have had a pervasive historical presence.⁵ In their formal model, assuming money is available to borrow at the cap rate, interest rate caps are welfare-enhancing because they provide a means for individuals to insure themselves cheaply against income shocks. In their model, consumers cannot self-insure with savings so they must borrow from other consumers.

Because usury laws play many roles, no single theory can explain all the roles. One theory to explain interest rate caps is rent-seeking by those who set them. Ekelund, Herbert, and Tollison, for example, argue that interest rate caps continued to exist in the Middle Ages because low rates benefited the Catholic Church, which was a heavy borrower.⁶

In the eighteenth century, usury laws in Britain mandated a 5 percent interest rate ceiling. The British laws formed the basis for usury laws in America. Against this historical backdrop, Benmelech and Moskowitz examined usury laws in America.

Benmelech and Moskowitz show that the maximum legal interest rate by state from 1641 to 1891 ranged from 5.73 percent (Virginia) to unbounded (California).⁷ The maximum legal rate had a median of 8 percent. The higher rate caps enacted in America likely helped to attract investment capital. Durkin, Elliehausen, and Zywicki state that legal limits were not always binding in the colonial period because they sometimes exceeded prevailing market interest rates.⁸ Benmelech and Moskowitz find that usury laws, when binding, reduce credit and economic activity.

To test why usury rates existed, Benmelech and Moskowitz use two competing theories: private interests with political power capture rents from others, versus public interests protect the underserved. They also suggest an interpretation of their results: that “regulation designed to serve the politically and financially weak has the unintended consequence of exacerbating their plight.”⁹

In 1836, William Cullen Bryant, the editor of the *New York Evening Post*, argued against interest rate caps. Bryant, in his passionate editorial, forcefully declared:

Such attempts [at restricting interest rates] have always been, and always will be, worse than fruitless. They not only do not answer the ostensible object, but they accomplish the reverse. They operate, like all restrictions on trade, to the injury of the very class they are framed to protect; they oppress the borrower for the advantage of the lender; they take from the poor to give to the rich.¹⁰

In a later section of this chapter, we present evidence from rigorous research that corroborates Bryant's viewpoint. The evidence shows that interest rate caps harm the exact people who they are designed to protect. In addition, restrictions of interest rates result in a shift of resources from the credit impaired to those that are not credit impaired.

THE ECONOMICS OF INTEREST RATE CAPS

Economists may not know much. But we know one thing very well: how to produce shortages and surpluses. Do you want a shortage? Have the government legislate a maximum price that is below the price that would otherwise prevail. If you want to create a shortage of tomatoes, for example, just pass a law that retailers can't sell tomatoes for more than two cents per pound. Instantly you'll have a tomato shortage.¹¹

Although his eloquent example features tomatoes, Milton Friedman's argument above applies to all markets—including credit markets. If the rate cap is set above the market-clearing interest rate, then the interest rate cap does not restrain trade: competition and interactions between borrowers and lenders will set the rate when the market interest rate is below the rate cap. If the rate cap imposed is lower than the market-clearing interest rate, an excess demand by consumers for credit will exist because the quantity of loanable funds demanded at that rate will be greater than the amount that lenders are willing to lend.

As shown in tables 1 and 2, some states have capped interest rates on small-dollar loans at a level that makes these loan products unprofitable for lenders. The demand, however, for small-dollar loans in these states is not zero. Borrowers will continue to seek credit through legal and illegal sources.

Table 1. State Regulations Concerning Traditional Installment Lending

Current and Historic Interest Rate Caps

State	2014 Maximum Annual Percentage Rate (APR) on a \$1,000 Loan (Source: AFSA)	2014 Dollar Interest Paid on a 12-Month, \$1,000 Loan at State's Maximum APR (Source: Author Calculations)	1935 Maximum Annual Percentage Rate (APR) on a \$100 Loan (\$1,728 in 2014 Dollars) (Source: Foster (1941))
<i>Panel A. Low rate cap states</i>			
1 Arkansas	17	94	10
2 Connecticut	17	94	36
3 Massachusetts	23	129	36
4 Pennsylvania	24(a)	135	36
5 District of Columbia	24	135	12
6 Nebraska	24	135	10
7 Rhode Island	24	135	36
8 Vermont	24	135	30
9 Hawaii	25	141	42
10 Michigan	25	141	36
11 New York	25	141	36
12 Washington	25	141	—
13 Alabama	26(a)	146	8
14 California	30	170	30
15 Florida	30	170	42
16 Maine	30	170	36
17 New Jersey	30	170	30
18 North Carolina	30	170	—
19 Oklahoma	30	170	—
20 Maryland	33	188	42
21 Minnesota	33	188	36
22 West Virginia	33	188	42
23 Ohio	28(a)	158	36
24 Tennessee	34(a)	194	6
<i>Panel B. States with rate cap of about 36%</i>			
1 Alaska	36	206	—
2 Arizona	36	206	42

Table 1. (continued)

State	2014 Maximum Annual Percentage Rate (APR) on a \$1,000 Loan (Source: AFSA)	2014 Dollar Interest Paid on a 12-Month, \$1,000 Loan at State's Maximum APR (Source: Author Calculations)	1935 Maximum Annual Percentage Rate (APR) on a \$100 Loan (\$1,728 in 2014 Dollars) (Source: Foster (1941))
3 Colorado	36(a)	206	10
4 <i>Indiana</i>	36	206	36
5 Iowa	36	206	36
6 <i>Kansas</i>	36	206	—
7 Kentucky	36	206	42
8 Louisiana	36	206	42
9 Mississippi	36	206	10
10 Montana	36	206	—
11 New Hampshire	36	206	24
12 <i>Oregon</i>	36	206	36
13 <i>Virginia</i>	36	206	42
14 Wyoming	36	206	—
<i>Panel C. States with higher rate caps</i>			
1 Georgia	40(b)	230	18
2 Nevada	40	230	—
3 Texas	80	484	10
4 Illinois	99	613	36
<i>Panel D. States with no rate cap</i>			
1 Delaware	No Cap	----(c)	8
2 Idaho	No Cap		—
3 Missouri	No Cap		36
4 New Mexico	No Cap		10
5 North Dakota	No Cap		—
6 South Carolina	No Cap, over \$640		—
7 South Dakota	No Cap		—
8 Utah	No Cap		36
9 Wisconsin	No Cap		30

Sources: (a) National Consumer Law Center, "Installment Loans" (b) "The Cost of Personal Borrowing in the United States"; American Financial Services Association (AFSA), "State Small Loan Lending Law Categories," 2014, www.afsaonline.org. Historic APRs are from Foster, "Personal Finance Business under Regulation," 154–72, table 1. States in bold italic are states that AFSA identifies as states without traditional installment lending. www.afsaonline.org. (c) With no cap, the amount paid is competitively determined.

Note: For a one-year \$1,000 loan, the allowable APR is 28%. However, the state of Ohio allows credit services organizations to charge an additional—uncapped—fee for arranging a loan.

Table 2. State Regulations Concerning Payday Lending

Legality, Interest Rate Caps, Maximum Loan Amounts, and Fees

State	Maximum Annual Percentage Rate (APR) on \$100 2-Week Payday Loan (Source: Consumer Federation of America)	Maximum Annual Percentage Rate (APR) on \$100 2-Week Payday Loan (Source: Community Financial Services Association of America)	Dollar Fee Paid on a \$100 2-Week Payday Loan at State's Maximum APR (Source: Community Financial Services Association of America)	Maximum Dollar Amount Permitted to Be Borrowed (Source: Consumer Federation of America)	Maximum Dollar Amount Permitted to Be Borrowed (Source: Community Financial Services Association of America)
<i>Panel A. Prohibited per CFED website</i>					
1 Arizona	—	—	—	—	—
2 Arkansas	—	—	—	—	—
3 Connecticut	—	—	—	—	—
4 District of Columbia	—	—	—	—	—
5 Georgia	—	—	—	—	—
6 Maine	—	—	—	—	—
7 Maryland	—	—	—	—	—
8 Massachusetts	—	—	—	—	—
9 New Jersey	—	—	—	—	—
10 New York	—	—	—	—	—
11 North Carolina	—	—	—	—	—
12 Pennsylvania	—	—	—	—	—
13 Vermont	—	—	—	—	—
14 West Virginia	—	—	—	—	—
<i>Panel B. Legal per CFED website, but de facto prohibited</i>					
1 Montana	36	—	—	300	Not specified
2 New Hampshire	36	—	—	500	Not specified
3 Oregon	36	—	—	Not specified	Not specified
4 Maine(a)	43(a)	—	—	None	Not specified
5 Colorado	—	—	(b)	500	500
<i>Panel C. Legal per CFED website, rate capped</i>					
1 Alabama	456	455	\$17.50	500	500
2 Alaska	443	520	\$20.00	500	500

Table 2. (continued)

State	Maximum Annual Percentage Rate (APR) on \$100 2-Week Payday Loan (Source: Consumer Federation of America)	Maximum Annual Percentage Rate (APR) on \$100 2-Week Payday Loan (Source: Community Financial Services Association of America)	Dollar Fee Paid on a \$100 2-Week Payday Loan at State's Maximum APR (Source: Community Financial Services Association of America)	Maximum Dollar Amount Permitted to Be Borrowed (Source: Consumer Federation of America)	Maximum Dollar Amount Permitted to Be Borrowed (Source: Community Financial Services Association of America)
3 California	460	459	\$17.65	300	300
4 Florida	342	390	\$15.00	500	500
5 Hawaii	460	459	\$17.65	600	600
6 Illinois	404	429	\$16.50	1,000	1,000
7 Indiana	391	390	\$15.00	550	605 or 20% of gross inc.
8 Iowa	358	433	\$16.67	500	500
9 Kansas	391	390	\$15.00	500	500
10 Kentucky	471	485	\$18.65	500	500
11 Louisiana	574	783	\$30.12	350	350
12 Michigan	375	402	\$15.45	600	600
13 Minnesota	235	390	\$15.00	350	350
14 Mississippi	572	520	\$20.00	400	500
15 Missouri	1,955	—	—	500	500
16 Nebraska	460	459	\$17.65	500	500
17 New Mexico	409	416	\$16.00	2,500	25% of gross inc.
18 North Dakota	520	538	\$20.68	500	600
19 Ohio(c)	390(c)	—	\$15.00(c)	500	800
20 Oklahoma	396	405	\$15.46	500	500
21 Rhode Island	261	260	\$10.00	500	500
22 South Carolina	391	400	\$15.40	550	550
23 Tennessee	313	459	\$17.65	425	500
24 Texas	309	—	\$11.87	Not specified	Not specified
25 Virginia	610	686	\$26.38	500	500
26 Washington	390	390	\$15.00	700	700 or 30% of gross inc.
27 Wyoming	313	780	\$30.00	Not specified	No limit

(continued)

Table 2. (continued)

State	Maximum Annual Percentage Rate (APR) on \$100 2-Week Payday Loan (Source: Consumer Federation of America)	Maximum Annual Percentage Rate (APR) on \$100 2-Week Payday Loan (Source: Community Financial Services Association of America)	Dollar Fee Paid on a \$100 2-Week Payday Loan at State's Maximum APR (Source: Community Financial Services Association of America)	Maximum Dollar Amount Permitted to Be Borrowed (Source: Consumer Federation of America)	Maximum Dollar Amount Permitted to Be Borrowed (Source: Community Financial Services Association of America)
<i>Panel D. Legal per CFED website, rate not capped by state</i>					
1 Delaware	—	—	—	500	1,000
2 Idaho	—	—	—	1,000	1,000 or 25% of gross inc.
3 Nevada	—	—	—	25% of Gross Inc.	25% of gross inc.
4 South Dakota	—	—	—	500	500
5 Utah	—	—	—	No limit	No limit
6 Wisconsin	—	—	—	1,500	1,500 or 35% of gross inc.

Sources: (a) Barth et al., “Do State Regulations Affect Payday Lender Concentration?” The Consumer Federation of America website (www.paydayloaninfo.org) says payday lending in Maine is prohibited. The Community Financial Services Association of America (www.cfsaa.com) has no data for Maine. (b) Colorado law provides a six-month minimum loan term with multiple payments. (c) Barth et al., “Do State Regulations Affect Payday Lender Concentration?”

Note: Community Financial Services Association (CFSA) information is as of July 1, 2014. Consumer Federation of America (CFED) information is as of October 20, 2015.

Blitz and Long state, “Legal rate ceilings may reduce the price of personal loan credit to some borrowers, but when ceilings are sufficiently low to affect the observed market rate in a significant way, there is a substantial reduction on the number of borrowers included in the legal market. Relatively low risk borrowers who remain in the legal lending market appear to benefit from the lower cost loans made when higher risk potential borrowers are excluded.”¹²

Durkin, Elliehausen, Staten, and Zywicki present a detailed discussion of the theoretical and empirical evidence on this issue.¹³ For example, Daniel Villegas studies the effect of interest rate caps on the quantity of credit provided to different risk classes of borrowers. He finds that rate ceilings negatively affect the quantity of credit available to low- and middle-income households living in states with rate caps.¹⁴ Economists would predict, however, that if the credit market cannot eliminate the excess demand for credit by high-risk

borrowers simply by raising the price (i.e., the interest rate) of the loans, then lenders will allocate their loanable funds through other means.

Consider the following example. Suppose an effective interest rate cap exists in a credit market. Lenders will supply some, but not all, of the loan funds demanded at the interest rate cap. This point is an important one: when lenders cannot use price to allocate loans, they must use some other criteria to allocate loanable funds. The result is almost surely that the credit demand of higher-risk borrowers will go unfulfilled.

Despite the many ways in which lending discrimination is illegal in the United States, an effective interest rate cap actually provides an incentive for lenders to discriminate when choosing borrowers. Research indicates, as one might expect, that lenders, when faced with binding interest rate caps, favor less risky and generally wealthier borrowers over those who are more risky.

Considerable research evidence exists that laws imposing interest rate caps harm the very people the proponents of the law are seeking to protect. For example, Bowsher states that the effects of interest rate caps are “arbitrary and weigh heaviest on those credit seekers generally considered most risky.”¹⁵ He also points out that a low interest rate cap prevents higher-risk individuals from competing for loanable funds. As a result, a greater share of the available loan funds flows to lower risk applicants—thereby increasing the volume of credit flowing to relatively wealthier borrowers. Relatively poorer borrowers, therefore, have a reduced access to credit.

Zinman shows that imposing a binding interest rate cap harms those with high debt burdens, because decreasing access to credit increases foreclosures, defaults, and bankruptcies.¹⁶ He, and Peterson and Falls,¹⁷ find that these borrowers are forced to shift into more expensive substitutes for installment loans. A shift into products such as check overdrafts and pawn shops worsens the financial conditions of borrowers.¹⁸ Zywicki contends that imposing more regulations on payday lenders will “make consumers worse off, stifle competition, and do little to protect consumers from concerns of over-indebtedness and high-cost lending.”¹⁹ He argues that unintended consequences, such as shifting borrowers into more expensive credit products, can occur because of heavy restrictions on payday lenders.

RESEARCH ON ARGUMENTS MADE FOR IMPOSING INTEREST RATE CAPS

Advocates of interest rate caps offer many arguments for the “need” for interest rate caps in small-dollar loan markets. One can collectively view these arguments

simply as “being in the best interest of consumers.” From our synthesis of the literature, popular arguments for interest rate caps include:

- a. Borrowers are naïve and simply do not understand the loan terms.
- b. Groups thought, by advocates, to be most vulnerable to exploitation by lenders—namely minorities, women, and the poor—need protection from “predatory” lenders.
- c. Even if consumers are willing to borrow at high interest rates, society should protect these consumers from themselves because they are making themselves worse off.
- d. Lenders, especially small-dollar lenders, make abnormally high profits from lending at high interest rates because they have considerable market power.

Borrowers Are Naïve and Do Not Understand Loan Terms

The literature on awareness of loan terms, especially annual percentage rates (APRs), is extensive, as summarized by Durkin and Elliehausen. They distill survey evidence that shows that consumers believe that it is not difficult to obtain information on credit costs.²⁰ Although consumer awareness of APRs extends to many credit products, this section mostly summarizes evidence regarding payday loans.

Elliehausen and Lawrence directly examine the question of whether borrowers who demand short-term credit are naïve and do not understand the terms of the loan. Presenting the results of a 2001 national survey of borrowers in the payday lending market, they find little, if any, support for the “naïve borrower” hypothesis.²¹ The survey results show that consumers understand the dollar cost (i.e., the finance charge) of payday loans. The survey results also show, however, that consumers generally do not recall the APR of these loans—even though the lender discloses the APR to the consumer. Elliehausen and Lawrence postulate that the result concerning recollection of the APR possibly stems from the desire of borrowers to know the dollar charges they face—such as check overdraft charges and late payment fees. Then, borrowers can compare these charges when making the financial decision to use a payday loan.

If so, this conjecture implies that APR is not likely to have as much influence on borrower behavior as does dollar cost. Rather than being uninformed and

naïve, high interest rate customers appear to be making rational decisions based on the dollar cost of short-term credit. Zinman posits that perhaps the closest substitute for a payday loan is bank overdraft protection—a considerably more expensive option.²² If one views these bank overdraft fees as interest charges, they could be much greater than the average APR calculation for a payday loan because the overdraft fee applies to even small check amounts relative to a typical payday loan.

Empirical studies also suggest that most consumers choose credit contracts that suit their needs. Recently, Miller presents the results of a survey for the state of Mississippi. Two questions in this survey are whether consumers know where to go to get a loan that suits their needs and whether they understand the terms of these loan products. Concerning the first question, Miller reports that whether the respondent has a bank account or not matters, and so does whether the person's education level stops at high school. Concerning the second question, he reports that what matters is whether the educational level of the respondent stops at high school.²³ If consumers make significant mistakes concerning credit, Durkin, Elliehausen, Staten, and Zywicki discuss how consumers tend to correct them.²⁴

The Most Vulnerable Need Protection from Predatory Lenders

Advocates of interest rate caps perceive consumers of high APR products as being the most “vulnerable” members of society—namely, women, minorities, and the poor. Advocates of rate caps call other potentially vulnerable members of society “unbanked” or “underbanked.”

Empirical Evidence Concerning Income of Borrowers. Barr presents evidence that low-income consumers in Detroit use high-rate borrowing.²⁵ He surveys these consumers and finds that their expenditures on these loans were quite low. His results suggest that these consumers are quite good at finding ways to avoid fees. That is, his results suggest that low-income consumers have some sophistication in using financial services that are appropriate to their circumstances and that users of high-rate credit products might not be as vulnerable to predatory lenders as critics suggest—despite their modest incomes and lower levels of formal education.

The empirical evidence drawn from payday borrowers shows that the typical payday loan customer is a young family that is credit-constrained. Moreover,

these payday borrowers do not fit the typical profile of “the unbanked” because borrowers must have a steady job and a checking account to qualify for a payday loan. Thus, one would expect that payday loan customers would not typically have the lowest incomes of small-dollar borrowers. Indeed, the 2001 national survey by Elliehausen and Lawrence²⁶ reported that, on average, only 23 percent of payday borrowers have family incomes below \$25,000 (\$31,759 in 2011 dollars), while 25 percent have incomes greater than \$50,000 (\$63,518).

In 2003, Stegman and Faris looked at the incomes of payday customers by certain states and noted the average incomes of payday borrowers were between \$25,000 to \$30,000 (\$38,111 in 2011 dollars) in Indiana, \$24,000 (\$30,489) in Illinois, and \$19,000 (\$24,137) in Wisconsin. DeYoung and Phillips reported an average income of \$41,500 (\$43,512 in 2011 dollars) in Colorado.²⁷

Despite the differences in income levels, there are some common characteristics reported in these studies. Payday customers are more likely to be younger families, employed, and credit constrained. Elliehausen and Lawrence report that these consumers are more likely than the population at large to have more debt and to have filed for bankruptcy. In addition, they report that payday borrowers are more likely to have poor credit and more likely to have been denied credit. About 94 percent of payday borrowers have attained a formal education level of at least a high school diploma.²⁸

Economics of the Physical Location of the Lenders. It is reasonable to assume that suppliers of a product prefer to locate near their customers. Locational studies have shown that convenience is a major determinant in consumer decisions regarding where to buy. Convenience is one method whereby firms compete with each other. Increasing convenience lowers search costs to the customer. Thus, greater convenience is a benefit to the borrowers.

As Stegman states, payday lenders compete with other lenders through both location and service.²⁹ One would predict that payday lending operations are more likely to be located in minority census tracts or near military bases. This prediction is based on the expectation that payday lenders would likely locate in census tracts with a high demand for their products—that is, in census tracts with lower incomes.

Locating in Minority Neighborhoods and Near Military Bases. To our knowledge, there are no nationwide studies on the location of payday lenders, although

existing studies reveal the distribution of payday loans by the race of the borrower. Stegman and Faris report that African-American families in North Carolina and Texas were found to be “about twice as likely to borrow from a payday lender as whites.”³⁰ Stegman’s results suggest that neighborhoods with high minority populations would be more likely to have payday lending stores than areas with smaller percentages of minorities.³¹

Graves and Peterson’s study of military bases in twenty states showed that there is a higher concentration of payday lenders around military bases than elsewhere in these states.³² Morgan notes this concentration simply signals a higher demand for loans by the residents of this area; Stegman buttresses this signaling notion by concluding that active-duty military personnel have a greater demand for payday loans than do civilians.³³ In addition, Morgan’s empirical analysis shows a beneficial impact on borrowers when the number of payday stores increases, finding that interest rates fall as the number of payday lending stores per capita increases. Competition among lenders benefits borrowers.

The Department of Defense issued a 2006 report on the demand for payday loans by military personnel. This report likely led to the Talent-Nelson Amendment that became law in October 2007.³⁴ Among other restrictions, the Talent-Nelson Amendment imposes a nationwide 36 percent interest rate cap on loans to members of the military.

Carrell and Zinman estimate the effects of payday loan access on military readiness and performance using Air Force personnel data. They find that payday borrowing is negatively correlated to military readiness—an assertion they attribute to the Department of Defense. Their findings are strongest among relatively inexperienced and financially unsophisticated airmen.³⁵

One would predict that the Talent-Nelson Amendment would likely curtail payday lending to members of the military—to their detriment. Brown and Cushman argue that income characteristics of military enlisted personnel are essentially similar to civilians of similar age.³⁶ Although military compensation is stable, cash expenditures are not because of features of the military lifestyle. Brown and Cushman find that all kinds of consumer credit, including credit cards and other short-term loans, can be appropriate for military personnel under circumstances that they, as rational consumers, determine for themselves. They find no evidence that the economic welfare of military enlisted personnel will be enhanced by restricting the types of credit available to them.

Society Should Protect Consumers from Themselves

Those who advance the hypothesis that consumers make themselves worse off by borrowing at high rates make an argument as follows: high rate borrowers cannot see how high interest rate products could harm them; therefore, others must protect these consumers from themselves. Two basic assertions these advocates make are that (1) lenders lure these consumers into borrowing at high interest rates and that, consequently, (2) many of them will spiral into an inextricable cycle of debt—commonly referred to as the “debt trap.” Ernst et al. states that the Center for Responsible Lending estimates the annual cost of the debt trap is \$3.4 billion.³⁷ Many advocates favor a ban on high interest rate loans to protect consumers from making decisions that will trap them in debt.³⁸ By extension, advocates of a ban on payday lending believe that consumers will have fewer financial problems if access to a legal, high interest rate loan product is eliminated.³⁹

The “Debt Trap.” Although anecdotal evidence regarding debt traps exists, rigorous research, not anecdotes, must provide the basis for sound policy concerning consumer credit markets. In a 2008 study to empirically test the “debt trap” hypothesis, Morgan and Strain examined the impact on consumers when legislation in Georgia (2004) and North Carolina (2005) closed payday lending operations in these two states.⁴⁰ In general, their findings do not support the predictions of the “debt trap” hypothesis. Instead, after the ban, Georgia households bounced more checks, had more complaints about debt collectors, and were more likely to file for bankruptcy under Chapter 7.⁴¹ Rather than finding that Georgia and North Carolina households had fewer financial difficulties after banning payday lending, Morgan and Strain find that residents of these states had more financial difficulties. That is, despite the intention to enhance consumer welfare, banning payday lending reduces consumer welfare.

In a separate study, Morgan also finds evidence contrary to the debt trap hypothesis.⁴² Households in states without usury ceilings on payday loans are less likely to be turned down for credit and do not report higher levels of debt. These households are also less likely to have missed a debt payment during the previous year. Morgan finds that this result is consistent with the notion that payday borrowing is used to avoid missing payments on other debt.

In a clever paper, Morse studies whether payday lending is wealth reducing or wealth enhancing by examining whether payday lenders “help distressed

individuals bridge financial shortfalls without incurring the greater expense of delinquency or default on obligations.⁴³ Morse examines the response to natural disasters as an experiment. Looking at California for the period 1996–2005, she finds that while natural disasters induce an increase in foreclosures, payday loans significantly offset this increase. She further examines whether banks are substitutes for payday lenders and finds that they are substitutes in only two of sixteen specifications. Morse concludes that payday lending is welfare enhancing and that “a move to ban payday lending is ill advised.”

Evidence from Arkansas and Oregon. Peterson, and Peterson and Falls, study the effects on Arkansas borrowers after a constitutional amendment made a 10 percent interest rate cap binding on all consumer loans.⁴⁴ Both studies find that after the 10 percent cap was imposed (1) small loan credit was not readily available, (2) many consumer finance companies ceased operations, and (3) depository lenders often stopped making small consumer loans. They also find that pawnbrokers in the state proliferated.

Peterson and Falls also note that when the Arkansas interest rate cap became binding, commercial banks and credit unions rationed credit by increasing the minimum size of a personal loan to more than two and one-half times the average minimum size of loans in other states. This action denies credit to consumers with a loan demand for a small-dollar amount. They also find that a higher proportion of Arkansas customers were rejected for credit than in other states, and find shorter loan maturities in Arkansas.⁴⁵ These results are consistent with the rationing of credit at the lower rates.

Arkansas consumers who were unable to find credit at the 10 percent cap substituted credit from pawn shops and point-of-sale credit.⁴⁶ As a result, point-of-sale credit purchase prices rose to levels that were higher in Arkansas than in the other states studied. The implication is that the state-imposed interest rate cap ceiling was welfare reducing. Higher-risk consumers had to patronize pawnbrokers and incur higher prices on point-of-sale credit purchases than consumers in other states.⁴⁷

As Collins and Sonstegaard note, the most serious effect of Arkansas’ legal restrictions on interest rates is that while affluent consumers can borrow out of state—the less affluent could find it difficult to borrow the funds needed during an emergency.⁴⁸ Thus, if the constitutionally imposed interest rate cap in Arkansas was designed to protect the poor, it failed to do so.

Zinman⁴⁹ studied the impact of the imposition of binding interest rate caps on consumer lending in Oregon. In 2007, Oregon instituted an APR interest rate cap of 150 percent. Because the bordering state of Washington did not impose such restrictions, Zinman constructed a careful study comparing the impact of interest rate caps on the access to credit in both states. He shows that the production costs of making these loans results in a breakeven APR rate of 390 percent for these payday lenders. After Oregon imposed the interest rate cap, the number of payday lenders in Oregon dropped from 346 to 82 by September 2008.

Zinman finds that the Oregon interest rate cap reduced the supply of credit for payday borrowers and that their financial condition worsened. After the cap was imposed, Oregon payday borrowers were more likely to “experience an adverse change in financial condition.”⁵⁰ In addition, borrowers in Oregon who would have been customers at payday lenders, shifted into what Zinman refers to as “incomplete and plausibly inferior substitutes” such as pawnbrokers and Internet lenders.⁵¹ Thus, the results presented by Zinman buttress the findings of the earlier study by Peterson.

Lenders Make Abnormally High Profits Because They Have the Market Power to Charge High Interest Rates

In this argument, market power enables lenders to set interest rates higher than those that would exist in a competitive market. Consequently, the argument continues, imposing an interest rate cap lowers the interest rate toward a competitive market interest rate. This argument, however, provides no answer to the following question. If one wants an interest rate closer to the competitive market rate, it is reasonable to ask; “Why not simply allow competitive interactions between borrowers and lenders and set market-clearing interest rates for various loan products?”

The economic argument for interest rate caps is that lenders likely have sufficient market power that they use to command “artificially” high interest rates. Economists, however, would find it quite curious that anyone could view an industry growing as fast as the payday lending industry as having concentrated market power and influence over interest rates.

Basic economics predicts that if an industry is earning abnormal profits, these profits will be competed away—either by price competition or by entry

of new firms. As of 2014, the CFPB estimates that there are 15,766 payday store locations in the United States—hardly a concentration of market power.⁵² In addition, there are many other competitors such as check cashing shops, pawnbrokers, consumer finance companies, banks, savings and loans, mutual savings banks, and credit unions. Consequently, this competition almost surely results in loan rates being lower than they would be without competition.

Morgan illustrates the effect of competition when he finds that the number of pawnshops in the United States stopped growing after the advent of the payday lending industry. He also points out that the payday lending industry is heavily regulated—therefore the costs of compliance are actually high.⁵³ High compliance costs limit entry, drive some existing firms out of business, and drive up costs to the remaining firms. Industry-wide, higher costs result in higher rates, and fewer dollars lent.

DeYoung and Phillips study payday loan interest rates in Colorado between 2000 and 2006,⁵⁴ and report results similar to those of Flannery and Samolyk. In the early years of their sample, DeYoung and Phillips found price competition among payday lenders. In the latter years of their sample, however, they found that payday lending rates moved toward the statutory limit and that noninterest rate competition emerged. They postulate that the lenders appear to be competing with convenience of the stores and the provision of customer service. DeYoung and Phillip also found that the firms practiced price differentiation, charging lower prices to first-time borrowers and higher prices to repeat customers. Multiple-location payday lenders charged higher prices than single store lenders.

At least two studies specifically investigate the payday lender profits. Flannery and Samolyk study payday store costs and profitability using proprietary store-level data from two large payday lenders. They do not find evidence of abnormally large profits and note: “To a great extent, the high APRs implied by payday loan fees can be justified by the fixed costs of keeping stores open and the relatively high default losses suffered on these loans.”⁵⁵

Huckstep compares the profitability of seven publicly traded payday lenders versus six mainstream commercial lenders and finds that “when compared to many other well-known lending institutions, payday lenders may fall far short in terms of profitability.”⁵⁶ Payday lenders averaged a 3.6 percent profit margin while mainstream commercial lenders had a profit margin of 13.0 percent. Because the payday lending profit margin is roughly one-fourth

the size of the profit margin of mainstream commercial lenders, Huckstep concludes that abnormally high profits for payday lenders are more myth than reality.

Although the payday lenders charge high fees, they incur high costs. Stegman and Faris state that banks have moved away from the brick and mortar model and have reduced branches by substituting electronic transactions; as a result, “fringe banks” have filled this void by offering more locations and extended business hours.⁵⁷ Huckstep adds that the cost of providing convenience to borrowers results in high rent costs, high wage costs, and high fixed costs associated with writing small loans.⁵⁸ Additional costs arise from high loan default rates and loan-monitoring activities to reduce the incidence of default.

The empirical evidence concerning the effects of competition in the installment lending business is also compelling. The National Commission on Consumer Finance (NCCF) devoted an entire chapter of its report to the issue of “Rates and Availability of Credit.” The Commission forcefully states: “The implications of these findings for public policy seem obvious: the only truly effective way of gaining ample supplies of personal loan credit for consumers *and* reasonable rates too, is to increase competition while simultaneously relaxing inordinately restrictive rate ceilings.”⁵⁹

LEGISLATION FOCUSED ON SMALL-DOLLAR LOANS

In the early twentieth century, lenders generally could not legally profit from making small-dollar loans at the state-imposed interest rates.⁶⁰ As a result, illegal lenders, eventually known as “loan sharks,” filled the demand for small-dollar loans.

During this period, many social reform causes, collectively known as the Progressive Movement, were under way in the United States.⁶¹ In 1907, the philanthropist Margaret Olivia Sage established the Russell Sage Foundation for “the improvement of social and living conditions in the United States.” In 1909, the Russell Sage Foundation turned its attention to consumer credit reform. Spearheaded by Arthur Ham, the Foundation sought ways to spread access to credit to workers. The credit reformers during this Progressive era did not seek to alter or regulate the behavior of those they wanted to protect. Instead, they sought ways, through research, to attract “legitimate” capital into the business of small-dollar installment lending. Importantly, reformers at the

time recognized that the needs of both lenders and borrowers had to be satisfied to create a sustainable alternative to the “loan shark.”⁶²

An Innovative Approach to Interest Rate Regulation and the Creation of an Industry

As detailed by Carruthers, Guinnane, and Lee,⁶³ the intent of the reformers was to pass laws that would allow specially licensed lenders to make small installment loans to consumers at interest rates above state-imposed caps. Through a series of rigorous studies, reformers decided that the costs and risks of providing small-dollar lending merited an interest rate of 3 percent to 3.5 percent per month—at least six times higher than the prevailing legal rates of about 6 percent per year.⁶⁴

In partnership with businesses willing to risk capital in lending small-dollar amounts to consumers, reformers, led by Arthur Ham, framed a pioneering model state law called the Uniform Small Loan Law of 1916. Members of the Russell Sage Foundation, academics, and legislatures deliberated, debated, and studied this model legislation as variants were enacted by states. By the early 1940s, as discussed in Hubachek, thirty states plus Hawaii, which was not a state at that time, had comprehensive small loan laws, nine had ineffective small loan laws, and nine had no small loan laws.⁶⁵

The Shift to More Federal Regulation in Consumer Credit Markets

Since the 1900s, state legislatures were heavily involved in regulating the small loan market. Michelman states that from 1904 to 1933, there were 1,078 bills relating to small loans introduced in state legislatures.⁶⁶ Many of these bills concerned the allowable rate of interest on these loans. Foster summarizes the state-mandated interest rate caps in effect in 1935.⁶⁷

In the ensuing three-quarters of a century, there have been many modifications to small loan laws in the various states. Table 1 (which is discussed in detail in a later section) summarizes the net result of state legislation from the mid-1930s to the present. Seventeen states (and the District of Columbia) currently have lower rate caps than they did in 1935. Sixteen states currently have higher rate caps than they did in 1935, and five currently have the same rate cap as they did in 1935. Foster did not report data for the remaining twelve (by current count) states.

The history of interest rate cap legislation in the various states between 1935 and 2015 remains a fertile area for research. State legislatures in particular would be interested in such a review and history.⁶⁸ From the mid-1930s until the late 1960s, states regulated the pricing terms in consumer credit markets. Starting in the mid-1960s, the federal government became more active in regulating the consumer credit market. In May 1968, the US Congress passed the Consumer Credit Protection Act. Title I of that Act was the Truth in Lending Act (TILA), commonly referred to as Regulation Z. Other federal legislation, like the Equal Credit Opportunity Act, followed in the 1970s.

Durkin, Elliehausen, Staten, and Zywicki detail many changes in the consumer credit market since the end of World War II.⁶⁹ A seminal Supreme Court ruling in 1978 concerned maximum interest rates on credit cards. In the landmark case, *Marquette National Bank of Minneapolis v. First of Omaha Service Corp.*, the Supreme Court ruling allowed credit card issuers to “export” nationally whatever interest rate was allowed in the state in which they were headquartered. To induce the companies to relocate, some states simply dropped their usury laws. Several large issuers relocated to these states. As a result of removing rate caps, market competition and the risk level of borrowers helped determine interest rates on credit cards.

As shown in Durkin, Elliehausen, Staten, and Zywicki, credit card borrowing increased dramatically after the ruling.⁷⁰ The impact on the installment loan business was that their “low risk” borrowers likely had more access to credit cards than their “high risk” borrowers did. If they did, this shift pressured profit margins for small-dollar lenders through an increase in bad debt expense. It is likely that installment lenders would have responded by improving underwriting techniques.

In addition, installment lenders could restore profit margins by making larger loans. As loan production costs increased, it is likely that, at some point, installment lenders could not make money by making loans below a certain size—likely less than \$1,000. If so, the unprofitability of these loans likely created a “credit desert” for a time in this loan space.⁷¹ Markets, like nature, abhor a vacuum.

Growth of the Payday Loan Industry

The payday loan industry emerged in the early 1990s and grew because of strong consumer demand and changing conditions in the financial services

marketplace. One important change was “the exiting of traditional financial institutions from the small-denomination, short-term credit market—a change largely due to its high cost structure.”⁷²

Today, consumer demand for the payday loan product is considerable and the market supply response to provide the payday loan product has been impressive. Bair states that payday lenders were virtually unheard of “15 years ago” (i.e., around 1990).⁷³ Caskey writes, “At the beginning of the 1990s, there were probably fewer than 200 payday loan offices nationally.”⁷⁴ Stegman reports that payday lenders lent about \$8 billion in 1999; Bair cites a study from a research firm that estimates that there were more than 22,000 payday store locations in 2004 and these stores extended about \$40 billion in short term loans.⁷⁵ In 2000, the industry consisted of 7,000 to 10,000 payday loan offices, rising to a peak of about 24,000 storefronts in 2006.⁷⁶

Hecht reports that, in 2013, there were about 17,800 payday loan storefront locations that provided \$30 billion in loans. He also reports that another \$15 billion was supplied by Internet payday lenders.⁷⁷ The continued existence of payday lenders is consistent with the notion that these lenders are fulfilling a demand for loans by borrowers that other lenders will not, or cannot, meet.

Dodd-Frank and the Creation of the Bureau of Consumer Financial Protection

In response to the financial crisis that peaked in the fall of 2008, the 848-page Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) became law only eighteen months later.⁷⁸ There was scant time for any rigorous research on the effects of Dodd-Frank regulations on many aspects of financial markets. An important part of Dodd-Frank is Title X. In its 108 sections and 158 pages, Title X established, and detailed the authority of, the Bureau of Consumer Financial Protection (CFPB). One of the general powers of the CFPB is to ensure that, “with respect to consumer financial products and services . . . consumers are protected from unfair, deceptive, or abusive acts and practices. . . .” Although the CFPB has broad authority to regulate financial markets, Title X does not grant the CFPB authority to impose interest rate caps on any loan or other extension of credit. Nonetheless, the existence of the CFPB and its organizational structure pose considerable “regulatory risk” for small-dollar lenders and their customers.⁷⁹

CURRENT STATE OF SMALL-DOLLAR LOAN LEGISLATION

Strictly speaking, there are two bona fide forms of non-credit card, small-dollar loans available to consumers today.⁸⁰ One—the payday loan—is a lump-sum loan paid back with interest at the end of the loan period. These loans typically have a two-week term. The other is a traditional installment loan. In an installment loan agreement, the borrower receives the proceeds today and pays back the loan in equal payments over the life of the loan. In an installment loan, the amount owed to the lender declines over the length of the loan. When the borrower makes the last payment, the borrower has paid back all interest and the principal. The appendix of this chapter contains a description and examples of the workings of these two loan products. States heavily and thoroughly regulate these loan products.

Existing Legislation in the Traditional Installment Loan Market

Table 1 contains a summary of existing small-dollar traditional installment loan laws, by state. The main data source in the table is the industry trade group for traditional installment lenders, the American Financial Services Association (AFSA). One can trace AFSA's roots back to the days when it, consumer advocates, and businesses sought to create alternatives to the "loan shark." AFSA publishes a report on "State Small Loan Lending Law Categories." Two additional raw data sources used to augment the AFSA publication are the appendix to a 2015 report from the National Consumer Law Center and a report called "The Cost of Personal Borrowing in the United States," by Carleton Inc.

It is important to note that rate ceilings are not always a single APR for all loans. In fact, many states have ceilings, graduated by size of loan, that are higher for smaller loans than for larger loans. In Mississippi, for example, as of 2015 the Small Loan Regulatory Law allowed 36 percent on the first \$1,000; 33 percent on an amount over \$1,000 but not exceeding \$2,500; 24 percent on an amount over \$2,500 but not exceeding \$5,000, and 14 percent on the remainder. Comparing graduated rate ceilings is difficult. The data from the AFSA in table 1 represents an attempt to convert these ceilings to APRs. This conversion helps make comparisons among states easier.

The rates provided by the AFSA report are interest rate ceilings only. That is, these APRs are the estimated interest charges on a \$1,000 loan. These APRs do not reflect other fees or costs of ancillary products (like credit insurance).

Foster⁸¹ contains data for the maximum APR allowed on a \$100 loan in 1935 (about \$1,728 in 2014 dollars). These maximum rates appear in column three of table 1.⁸²

No state bans traditional installment lending. Per AFSA, however, traditional installment lenders operate in only thirty-three states. In the remaining seventeen states and the District of Columbia, state-imposed interest rate caps are such that lenders cannot profitably make installment loans. In these states, the APR of the state-imposed interest rate cap ranges from 17 percent (Arkansas) to 36 percent (Indiana and Virginia). It is interesting to note, however, that in seventeen of the states where traditional installment lenders operate, the state-imposed maximum interest rate is 36 percent or less.⁸³

The data in table 1 are presented in four groups. Panel A contains a list of states with “Low” rate caps, most 33 percent and below; of the twenty-three states for which Foster presents data, fourteen have a current rate cap lower than the cap in 1935 and four states (and the District of Columbia) have a current rate cap higher than the cap in 1935. Panel B contains a list of fourteen states with a current interest rate cap of 36 percent; of these states, Foster presents data for ten of them. Four have a current cap rate lower than the cap in 1935, three have a higher rate, and three states have rate caps today equal to the rate cap in 1935.

Panel C lists four states with a current rate cap greater than 36 percent. As shown in panel D of table 1, only nine states—Delaware, Idaho, Missouri, New Mexico, North Dakota, South Carolina (on loans over \$640), South Dakota, Utah, and Wisconsin—have no rate cap. Instead, these states allow borrowers and lenders to agree on a rate appropriate for the loan size, likely resulting in a wide range of possible loan sizes in these states. Two others, Texas and Illinois, offer rates that likely result in a wide range of possible loan sizes. As shown in table 1, Foster presents data for eight of the thirteen states listed in panels C and D. All eight have a current rate cap that exceeds the rate cap in 1935.

Consequences of a 36 Percent Interest Rate Cap on Installment Loans

Twenty-three states and the District of Columbia have current rate caps less than 36 percent, fourteen states have an interest rate cap of 36 percent, and two more have caps slightly higher. The consequences of this rate cap level combined with

inflation has likely led to a widespread “loan desert” for installment loans for amounts less than \$1,000. The reason is simple. The interest income on a \$1,000 loan with a 36 percent APR is the same amount, \$206, regardless of what year the loan is made, but costs increase over time with inflation.⁸⁴

In making an installment loan, there are significant production costs that increase over time with inflation. In the period 1971–1972, the NCCF, a federal government study commission authorized by the federal Consumer Credit Protection Act, studied the breakeven APR by loan size. These breakeven APRs were calculated using careful cost estimates from Smith.⁸⁵ The NCCF estimates a fixed cost of \$50 to produce and collect the loan. In addition, the NCCF adds an 11 percent variable cost markup. This 11 percent variable cost allowance includes, presumably, a “normal” economic pretax profit.

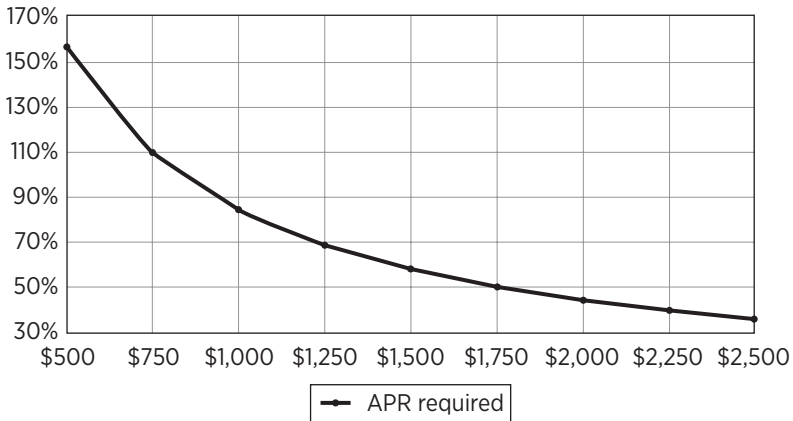
Under these assumptions, the NCCF estimates that a \$300 loan in 1972 has a 39.6 percent breakeven APR. For other loan sizes, the breakeven APRs (in parentheses) were estimated as \$400 (32.7 percent), \$500 (28.3 percent), \$700 (23.5 percent), \$1,000 (19.8 percent), \$2,100 (15.2 percent), and \$2,600 (14.4 percent) breakeven APR.

Durkin, Elliehausen, and Hwang update the NCCF estimates by restating the costs of making these loans into 2013 dollars.⁸⁶ They find that a \$700 loan has a breakeven APR of 91.4 percent and a \$1,000 loan has a breakeven APR of 77.9 percent, a \$2,100 loan has a breakeven APR of 42.0 percent, and a loan of \$2,600 has a breakeven APR of 36 percent.

Traditional installment lenders are competitive enterprises that must make a profit to remain in business. In states with a 36 percent rate cap, the implication of these higher breakeven rates is that traditional installment lenders will be making larger dollar loans in 2013 than they were in 1972 (or in any year with an inflation index lower than the level in 2013). The consequence of these higher breakeven rates, coupled with a 36 percent rate cap, is that there is likely an installment “loan desert” below some loan size, perhaps \$2,600.

Figure 1 shows this loan desert graphically; in the figure a breakeven loan size of \$2,500 is assumed. A one-year installment loan of \$2,500 at 36 percent APR paid monthly generates \$514 of interest. Suppose \$514 represents the total fixed costs, variable costs, and normal profit for making an installment loan. Figure 1 compares a rate cap of 36 percent to the APR required in order

Figure 1. Approximate APR Required to Generate \$514 Interest Income, by Loan Size (Assuming One-Year Loan with Monthly Payments)



Note: Original loan production cost and risk data are from Smith, "Recent Trends in the Financial Position of Nine Major Consumer Finance Companies." Smith's data appears in the report of the National Commission on Consumer Finance, Consumer Credit in the United States, exhibit 7-16, under rates that would "allow for enlargement of the market through a higher degree of risk acceptance." Durkin, Elliehausen, and Hwang, in "Rate Ceilings and the Distribution of Small Dollar Installment Loans," discuss the Commission's procedure in detail and they update the Commission's exhibit in their figure 1 by restating the costs per loan in 2013 dollars, so that a loan size somewhere between \$2,200 and \$2,700 has a breakeven rate of 36 percent (2013 dollars). In figure 1 as shown here, a breakeven loan size of \$2,500 is assumed. A one-year installment loan of \$2,500 at 36 percent APR paid monthly generates \$514 of interest; as shown here the APR must increase as the loan size decreases in order to generate \$514 of interest.

to generate \$514 of interest as the loan size decreases. One can see that the APR required increases as the loan size decreases.

In states with a higher rate cap, however, there will be a wider range in the dollar amount lent by traditional installment lenders. Durkin, Elliehausen, and Hwang show that nearly half the installment loans in their study occur in five states with rate caps ranging from 40 percent to uncapped.⁸⁷ The median loan size ranged from \$701 (Texas) to \$1,102 (Illinois).

Existing Payday Loan Legislation

Payday loans are a popular type of lump-sum loan. In a payday loan transaction, a borrower writes a check to a lender in exchange for a short-term cash loan, generally for about two weeks. The lender agrees to cash the check on, or after, the date specified in the loan. Table 2 contains a summary of existing

payday loan laws, by state. Data for this table is primarily from two sources: (1) the Community Financial Services Association of America (CFSA), which provided information privately, and (2) a web resource provided by the Consumer Federation of America (CFED), which attempts to maintain an information resource for advocates and consumers.⁸⁸

As displayed in panel A of table 2, thirteen states and the District of Columbia prohibit the lump-sum payday lending product. As shown in panel B of table 2, the laws in three other states do not expressly prohibit payday lending, but the state-imposed interest rate cap in those states likely makes payday lending unprofitable. Maine appears in both panels because one database classifies it as prohibiting payday lending, while another classifies it as having an APR of 43 percent.⁸⁹ The new payday lending law in Colorado does not allow lump-sum payday lending. Instead, the law requires multiple payments on a payday loan.

States regulate payday lenders in many different ways. One common way is to set a maximum fee allowed on a payday loan transaction. Sources often annualize and report this fee, which, as reported in table 2, ranges from \$10.00 to \$30.12 on a two-week \$100 payday loan. A second common way that states regulate payday loan transactions is by the amount of money that a payday lender can loan to a borrower in a payday loan. Panel C contains a list of states with caps on fees (and their annualized rates) and with a cap on the state-allowed amount borrowed. Two columns in panel C show the annualized rates at the time the raw data was gathered. Two other columns show the state-allowed maximum amount borrowed. This maximum amount is either a stated amount or a percentage of the borrower's gross income. The last two columns in panel C show these maximum amounts.

At the time the raw data was gathered, all states but three, Texas, Wyoming, and Utah, set a maximum borrowing amount for payday loans.⁹⁰ The maximum allowable amount ranges from \$300 (California and Montana) to \$2,500 (New Mexico). The most common maximum amount is \$500 (fifteen states per CFSA and seventeen states per CFED), with one (or two per the CFED) at \$550, three (or two) at \$600, and one (per the CFED) at \$700. Only four states allow a maximum loan amount of \$1,000 or more: Idaho and Illinois at \$1,000; Wisconsin at \$1,500; and New Mexico at \$2,500.

Panel D of table 2 contains a list of the six states where payday lending is legal and without one (or both) of the state-imposed restrictions. Only one, Utah, has neither restriction.

CONCRETE ACTIONS FOR ADVOCATES, ACADEMICS, AND LEGISLATURES IN MOVING FORWARD IN SMALL-DOLLAR LOAN LEGISLATION

Consider Adding Other Measures of the Cost of Small-Dollar Loans

It is easy for consumer advocates and others to catch “APR fever.” After all, most consumer advocates have had personal experience with traditional credit products, such as home mortgages, wherein APRs and changes in APR matter. For example, all else equal, an interest rate increase of 1 percent (i.e., 100 basis points) on a \$200,000 fixed-rate, thirty-year mortgage increases the interest cost to the consumer by \$40,000 over the life of the loan.⁹¹

The APR is a useful disclosure for a wide range of consumer credit products. Consumers can readily compare the costs of many consumer credit products offered by different types of lenders using the APR, even if they do not understand the mathematics. However, the APR is not useful and is potentially misleading in some circumstances. Durkin and Elliehausen argue that these circumstances include joint purchases of credit and other products, such as credit insurance.⁹² Durkin and Elliehausen also argue that APRs are not useful and are perhaps misleading for short-term (less than a year) loans.⁹³

Some credit decisions are inherently difficult and a single number should likely not be used to make these decisions. Mors provides a good discussion on assessing the cost of credit and argues that depending on circumstances, several types of information may be useful, including an effective interest rate (APR), finance charge, monthly payment and term to maturity, and simple interest rate.⁹⁴

In the small-dollar loan market, using only an APR as a loan cost indicator presents a skewed view of the cost of borrowing. Research results show that consumers are more concerned about the dollar costs of borrowing than the APR. Consumers can easily compare the dollar costs of loans and can easily understand them. Elliehausen and Lawrence show that borrowers only recall dollar costs, even though lenders disclose APR as well as dollar costs;⁹⁵ one study of the small-dollar loan market posits that dollar costs are a better loan cost indicator than APR for consumers.⁹⁶ DeYoung and Phillips show that APR is a poor predictor of the behavior of payday borrowers with respect to payday loan pricing.⁹⁷

Consumers who do not have enough money to pay their current bills know that they could face charges for nonsufficient funds, penalties and late fees, as well as reconnection fees for their utilities. For example, the Center for

Responsible Lending reports that consumers were assessed \$10 billion in overdraft charges in 2005 alone.

If one converts these charges to an implied APR, the costs of paying these charges exceed the interest rates from lump-sum payday lenders. Suppose a consumer writes a \$100 check, but does not have sufficient funds in the account. Furthermore, suppose the overdraft fee is \$40. If the consumer pays the \$40 overdraft fee in two weeks, the computed APR is \$1,040.⁹⁸ By contrast, a \$100 two-week payday loan with an APR of 520 percent, costs the consumer only \$20—half as much as the potential overdraft fee.

Tescher advocates the “TIP” calculation as a standard “by which to judge comparably the cost of short-term, small-dollar loans, regardless of what they are called.”⁹⁹ The TIP ratio is calculated by dividing the total interest by the principal of the loan. A two-week \$500 lump sum payday loan with a 20 percent fee (an APR of 520 percent) has a TIP ratio of 20 percent. A twelve-month \$1,000 traditional installment loan with an APR of 36 percent has a TIP ratio of 21 percent.¹⁰⁰

The TIP ratio is much lower for the lump-sum payday loans and traditional installment loans than it is for a traditional fixed rate mortgage. A \$200,000 thirty-year mortgage at a 4 percent APR has a TIP ratio of 72 percent. A \$1,000 traditional installment loan with an APR of 96 percent has a TIP ratio of 59 percent.¹⁰¹ Mortgages are neither short term in nature nor do they involve small amounts of money. However, these loans are expensive for consumers via the TIP calculation when compared to any of the lump-sum payday loans or traditional installment loans given. The lesson from a TIP calculation is that focusing only on the APR conceals the dollar costs paid by the consumer.

Allow Different Interest Rates for Different Amounts Borrowed

Recall that rate ceilings are not always a single APR. In fact, many states have ceilings graduated by size of loan that are higher for smaller loans than for larger loans. The Uniform Small Loan Law of 1916 provides a classic example of a graduated rate. From Section 13:

Every licensee hereunder may lend any sum of money not to exceed three hundred dollars (\$300) in amount and may

contract for and receive thereon charges at a rate not exceeding three and one-half per centum (3½ percent) per month on that part of the unpaid principal balance of any loan not in excess of one hundred dollars (\$100) and two and one-half per centum (2½ percent) per month on any remainder of such unpaid principal balance.

Today, some states allow much higher rates for very small loan sizes. Durkin, Elliehausen, and Hwang¹⁰² illustrate the effect of these higher rate ceilings on the distribution of loan sizes and APRs. In general, one observes small loan sizes when the law allows higher rates for small loan sizes.

Installment loans, like other goods, have production costs.¹⁰³ The biggest production cost facing installment lenders is underwriting the loan, which involves employees spending time assessing the ability of the borrower to repay the loan and filling out paperwork required by regulation. After making the loan, the lender faces another significant cost—the time spent monitoring the loan to ensure timely repayment. Lenders must pay for the money that they acquire to lend to their borrowers and, like any brick-and-mortar business, the lender has rent, utilities, salaries, and benefits costs.

Because production costs for small-dollar loans are roughly the same as production costs of larger-dollar loans, loans with low principal amounts are not as likely to be made under binding interest rate caps. To make small-dollar loans, lenders must earn a dollar profit that supports offering these loans. Under a binding interest rate cap, these small-dollar loans do not provide sufficient income to cover costs. Breakeven interest rates, therefore, increase as the loan size falls. Durkin, Elliehausen, and Hwang summarize the compelling evidence from the National Commission on Consumer Finance that a rate cap precludes the offering of a wide range of small-dollar loans.¹⁰⁴

Study the Effects of Interest Rate Caps Thoroughly before Imposing Them

Michelman states that social reformers of the early 1900s placed great emphasis on thoroughly and carefully studying an issue first, and only then passing laws based on the results of these studies.¹⁰⁵ In 1909, the Russell Sage Foundation

took this approach when it charged Arthur H. Ham to “study the Remedial Loan Associations of the country, to give advice to societies already established as to methods of work, and to give advice to those who wish to know about the formation of new societies.”¹⁰⁶

Anderson reports that in November 1911, Arthur Ham addressed the fifth annual convention of the Maine Conference of Charities and Corrections.¹⁰⁷ At a time when rate ceilings made profitable small-loan lending impossible, Ham outlined the need for small-dollar loan reform by saying:

We should not lose sight of the fact that the average annual earnings of the workingman in American cities is hardly more than \$500 and . . . that the average family . . . cannot maintain a normal standard of living on this amount of income. Consequently, it becomes immediately apparent that in time of sickness or similar crisis almost every wage-earner is forced to borrow money. . . . It is a regrettable fact that . . . the small loan business in this country has been almost entirely, and even now, is very largely in the hands of discredited and disreputable people [i.e., “loan sharks”], who . . . fatten upon the misfortunes and the necessities of the deserving.

Arthur Ham’s plea for freeing citizens from “discredited and disreputable” lenders (i.e., “loan sharks”) is consistent with access to credit being an important aspect of the fundamental freedom to enter wealth-enhancing contracts.

The problems American consumers face concerning income disruptions and expense shocks have not materially changed in the past 100 years. What has changed in the interest rate legislation arena is the abandonment of a deliberate legislative process following careful study. Let us return to that culture of studying interest costs through rigorous and unbiased study. The best example of this approach is the 1972 report of the National Commission on Consumer Finance. Perhaps it is time for another large-scale study of the current state of consumer credit in the United States.

Revise or Eliminate Interest Rate Caps

A comment in Hubachek's 1941 article is still relevant. It begins:

The maximum rate of charge of 3½ per cent a month on that part of any loan balance not exceeding \$100 and 2½ per cent a month on that part exceeding \$100 is recommended as an initial rate in all states. This combination of rates permits a maximum charge ranging from 3½ per cent a month on outstanding balances of \$100 or less to 2.83 per cent a month on outstanding balances of \$300. The rate is designed to attract aggressive competition by licensed lenders following the enactment of the law in order to drive unlicensed lenders out of business. *This rate should be reconsidered after a reasonable period of experience with it.* (emphasis added)¹⁰⁸

Clearly, 100-plus years certainly exceeds “a reasonable period.” There is a need for exhaustive, and extensive, research that examines any small-dollar loan market where buyers and sellers contractually agree to loan terms, particularly the interest rate. As shown in table 1, many states have kept interest rate caps on traditional installment loans at the maximum APR of 36 percent or below.

In the lump-sum payday loan space, there is only one state, Utah, with no limit on the dollar amount of a payday loan or an interest rate cap. Five other states, Delaware, Idaho, Nevada, South Dakota, and Wisconsin, impose no rate cap on lump-sum payday loans, but limit the dollar amount. Missouri imposes a 1,955 percent APR on payday loans.

In the traditional installment loan space, there are a few more states available for researchers to study a loan market where borrowers and lenders can freely enter into loan agreements (i.e., no rate cap). As shown in table 1, states that allow borrowers and lenders to enter into loans by contract are Delaware, Idaho, Missouri, New Mexico, North Dakota, South Carolina (for amounts over \$640), South Dakota, Utah, and Wisconsin. Additionally, Texas and Illinois allow for rates higher than the bulk of the other states.

Legislatures can learn from the range of loan sizes in these “by contract” states and the frequency of these loans. If a wide range of loan sizes exists, this fact is consistent with the notion that the borrower has access to a loan that

is “right” for her. Then, one can compare the range and frequency of loan sizes across interest rate cap categories. By doing so, one can estimate the costs of interest rate caps to consumers.

The National Commission on Consumer Finance makes a strong statement on this issue. It states,

The Commission recommends that each state evaluate the competitiveness of its markets before considering raising or lowering rate ceilings from present levels. Policies designed to promote competition should be given the first priority, with adjustment of rate ceilings used as a complement to expand the availability of credit. As the development of workably competitive markets decreases the need for rate ceilings to combat market power in concentrated markets, such ceilings may be raised or removed.¹⁰⁹

CONCLUSION

For a variety of reasons, since the beginning of recorded history, lawmakers have looked on the ownership of money, and the charges for its use, differently from the ownership of other assets and the charges for their use. Consequently, setting interest rate caps on loans has long been a focus of religious leaders and a wide variety of governments and their agents. A belief in the effectiveness of interest rate caps endures despite many empirical studies showing that not only are interest rate caps ineffective, they harm their intended beneficiaries.

Fundamentally, because interest rate caps are a market-distorting action, imposing an interest rate cap or banning loan products reduces the well-being of parties who would have otherwise engaged in trade. Nonetheless, advocates continue to argue for interest rate caps. Their arguments fall into four general categories:

1. Borrowers are naïve and simply do not understand the loan terms.
2. Groups thought to be most vulnerable to exploitation by lenders—namely minorities, women, and the poor—need protection from predatory lenders.

3. Even if consumers are willing to borrow at high interest rates, society should protect these consumers from themselves because they are making themselves worse off.
4. Lenders, especially small-dollar lenders, make abnormally high profits from lending at high interest rates because they have considerable market power.

This chapter summarizes a large body of rigorous research that examines these arguments. Little, if any, empirical evidence supports any of these four arguments.

Many consumer advocates have had personal experience with traditional credit products such as high-limit credit cards, home mortgages, and personal lines of credit. Few, however, share the daily budgetary concerns facing many hourly workers. These workers generally have lower income levels and lower levels of wealth. As a result, income disruptions and/or expense shocks have a profound impact on their ability to pay bills.

Today, there are two dominant forms of small-dollar loan products available to consumers who seek nonbank-provided credit: a lump-sum payday loan, paid back with interest at the end of the loan period, and a traditional installment loan, in which the borrower makes equally spaced, equal payments over the life of the loan.

Existing payday and traditional installment lending legislation severely restricts access to these credit products. Twelve (or thirteen, depending on Maine's classification) states and the District of Columbia place outright bans on the payday lending product. The laws in four other states do not expressly prohibit payday lending, but the state-imposed interest rate cap in those states likely precludes the lump-sum payday lending product. In addition, Colorado law imposes an installment payment plan instead of allowing the lump-sum loan product.

All states but one, Utah, set a maximum borrowing amount for payday loans. The maximum allowable amount ranges from \$300 (California and Montana) to \$2,500 (New Mexico), while the most common maximum amount is \$500 (seventeen states).

Where legal, the maximum APR of payday lending interest rates range from 36 percent (Montana, New Hampshire, and Oregon) to 1,955 percent (Missouri). Only six states allow the parties to the loan to set the interest rate by contract.

Advocates and legislators often ignore the actual dollar cost of a payday loan. For a \$100, fourteen-day payday loan with an APR of 790 percent, the interest expense to the consumer is only \$30. Clearly, it is easier to foster and bolster passion to oppose an APR of 790 percent than the corresponding \$30 interest expense.

No state bans traditional installment lending. The AFSA trade association reports, however, that traditional installment lenders do not operate in seventeen states (or the District of Columbia). The names of these states appear in bold italics in table 1. The APR in these seventeen states and the District of Columbia ranges from 17 percent (Arkansas and Connecticut) to 36 percent (Arizona, Indiana, Kansas, Oregon, and Virginia).

Moving forward, we propose four concrete actions for researchers to study and provide results to consumer advocates and legislators. These actions are:

1. Include other ways to measure the cost of small-dollar loans.
2. Allow different interest rates for different amounts borrowed.
3. Return to studying interest rates thoroughly before regulating them.
4. Revise, or eliminate, interest rate caps.

Each of these actions allows or enhances voluntary exchange that benefits both borrowers and lenders. Both parties in a voluntary trade are better off after the trade than they were before the trade. If they were not, they would not trade. In lending, there would be no loan agreement unless both parties were better off by making the loan.

Every day, consumers make choices based on the price of money—just as they respond to prices of other goods and services. The market for credit is not “special” or “different”; it also obeys the laws of supply and demand. Consequently, as in any market that obeys the laws of supply and demand, letting the market determine prices and quantities will greatly benefit the participants in the small-dollar loan market.

APPENDIX

Suppose a consumer desires to obtain a bona fide small-dollar loan from an in-the-flesh lender. This consumer essentially has two choices: a traditional installment loan from a finance company or a payday loan.¹¹⁰

Traditional Installment Loans

In the early 1900s, a battle raged against illegal “loan sharks” and an alternate new loan source emerged through the collaboration of lenders who wanted to offer this new product and consumer advocates, notably Arthur H. Ham of the Russell Sage Foundation. What emerged was the Uniform Small Loan Law written in 1916. By the 1960s, almost all states had adopted some version of this model law.¹¹¹

The striking feature of this law was that it allowed for interest rates higher than allowed under existing usury laws. Of course, both illegal “loan sharks” and those who favored low interest rate ceilings lobbied long and hard against this legislation. When collaborating on the Uniform Small Loan Law, the parties agreed on the following: (1) Legal installment lenders must be able to earn a reasonable profit. Therefore, the interest rate was initially set at 3 to 3.5 percent per month; (2) small loans were defined as “up to \$300” (in today’s dollars, about \$7,137), and (3) the interest rate would be reexamined periodically to sustain the industry.

As an example of an installment loan, suppose a consumer wants to borrow \$1,000 to pay for vehicle repairs. The terms of the loan are twelve months, an annual interest rate of 36 percent (3 percent per month), and no closing fee (for ease of calculation). To calculate the loan payment, we use the following two equations:

$$\$P = \$C \left[\frac{1 - \text{Present Value Factor}}{r} \right]$$

where:

$$\text{Present Value Factor} = \frac{1}{(1+r)^T}$$

In this example, the Present Value Factor is $= \frac{1}{(1+.03)^{12}} = 0.70138$. The resulting monthly payment is

$$\$1,000 = \$C \left[\frac{1 - 0.70138}{.03} \right] = \$C [9.9540],$$

and we can calculate $\$C = \100.46 . The total of interest and principal payments equals the payment times the number of payments, or $\$100.46$ times 12, or $\$1,205.55$. The consumer borrowed $\$1,000$, so the consumer pays $\$205.55$ in interest over the life of the loan. Notice that the consumer does NOT pay $\$1,000$ times 0.36, or $\$360$, in interest. The difference between $\$360$ and $\$205.55$ occurs because the amount owed each month declines, or amortizes, over the length of the loan. Therefore, even though the interest rate of 36 percent determines the size of the installment payment, the interest income received by the lender is $\$205.55$, or 20.56 percent of $\$1,000$.

Payday Loans

A payday loan is a short-term, lump-sum loan. Most of the loans are for a term of thirty days or less. (Payday loans are also known as cash advance loans, delayed deposit loans, and deferred presentment loans.) In a traditional payday loan, a borrower writes a check to a lender in exchange for a short-term cash loan. The lender agrees not to cash the check until a date specified in the loan agreement.

To obtain a payday loan, lenders generally require borrowers to have an active checking account, provide proof of income, show valid identification, and be at least eighteen years old. Payday lenders generally do not require a traditional credit report.

As of September 6, 2016, according to the website for the National Conference of State Legislatures: “Thirty-eight states have specific statutes that allow for payday lending. Eleven jurisdictions do not have specific payday lending statutory provisions and/or require lenders to comply with interest rate caps on consumer loans . . . [while] . . . Arizona and North Carolina allowed pre-existing payday lending statutes to sunset. Arkansas repealed its pre-existing statute in 2011.”¹¹²

Mississippi law, for example, allows a payday lender to charge a fee of up to $\$20$ per $\$100$ advanced to the borrower. For example, if a borrower writes a check for $\$240$, the lender advances $\$200$ to the borrower and keeps the check, which includes $\$40$ in fees. Assuming this loan is for two weeks, the annual percentage rate is $\$40/\200 times 26 = 520 percent.

NOTES

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1. Michelman, *Consumer Finance*, 87–88.
2. Homer and Sylla, *History of Interest Rates*.
3. For the interested reader, many authors document the history of interest rates and lending. An incomplete list includes Michelman, *Consumer Finance*; Homer and Sylla, *History of Interest Rates*; Smith, “Rethinking Usury Laws”; Horack, “Survey of the General Usury Laws,” 36–53; Glaeser and Scheinkman, “Neither a Borrower nor a Lender Be,” 1–6; Calder, *Financing the American Dream*; Botticini, “Tale of ‘Benevolent’ Governments,” 164–89; Anderson, “Experts, Ideas, and Policy Changes,” 271–310; Graeber, *Debt*; Durkin, Elliehausen, and Hwang, “Rate Ceilings”; Durkin, Elliehausen, and Zywicki, “Consumer Credit and the American Economy”; Durkin et al., *Consumer Credit and the American Economy*.
4. See Homer and Sylla, *History of Interest Rates*.
5. Glaeser and Scheinkman, “Neither a Borrower nor a Lender Be.”
6. Ekelund, Herbert, and Tollison, “Economic Model of the Medieval Church,” 307–31. They do not claim that the Church invented the doctrine of interest rate restrictions merely for economic gain. Rather, they state that the doctrine was imposed (and modified through time) for other religious reasons. The Church likely did recognize, however, the benefit of low rates when it borrowed.
7. Benmelech and Moskowitz, “Political Economy of Financial Regulation,” 1029–73.
8. Durkin, Elliehausen, and Zywicki, “Consumer Credit and the American Economy.”
9. Benmelech and Moskowitz, “Political Economy of Financial Regulation,” 1030.
10. Bryant, “On Usury Laws.”
11. Milton Friedman cited in Friedman and Friedman, *Free to Choose*, 219.
12. Blitz and Long, “Economics of Usury Regulation,” 608–19.
13. Durkin et al., *Consumer Credit and the American Economy*.
14. Villegas, “Impact of Usury Ceilings on Consumer Credit,” 126–41.
15. Bowsher, “Usury Laws,” 18.
16. Zinman, “Restricting Consumer Credit Access,” 546–56.
17. *Ibid.*; Peterson and Falls, “Impact of a Ten Percent Usury Ceiling.”
18. Ernst, Farris, and King, “Quantifying the Economic Costs.” They contend that banning high interest rate loans benefits consumers with high debt burdens and argue that because consumers spend \$3.4 billion (in their study) in interest charges, consumers will instead save most of this amount. Morgan and Strain in “Payday Holiday” point out that Ernst et al. ignore the interest costs resulting from customers resorting to higher cost loans and the costs of increased financial stress.
19. Zywicki, “Case against New Restrictions,” 1.

20. Durkin and Elliehausen, *Truth in Lending*.
21. Elliehausen and Lawrence, "Payday Advance Credit in America."
22. Zinman, "Restricting Consumer Credit Access," 548n18: "Bouncing checks is quite costly due to insufficient funds and returned-check fees . . . the bank often charges the account holder [a] fee of \$20 or more; hence in many cases getting a payday loan is cheaper than over-drawing the checking account (particularly if the account holder runs the risk of overdrawing multiple checks)."
23. Miller, "Differences in Consumer Credit Choices."
24. Durkin et al., *Consumer Credit and the American Economy*.
25. Barr, *No Slack*.
26. Elliehausen and Lawrence, "Payday Advance Credit in America."
27. See Stegman and Faris, "Payday Lending"; DeYoung and Phillips, "Payday Loan Pricing." Dollar values are adjusted by the Consumer Price Index from the St. Louis Federal Reserve Bank.
28. Elliehausen and Lawrence, "Payday Advance Credit in America," Table 5-6.
29. Stegman, "Payday Lending."
30. Stegman and Faris, "Payday Lending." This finding is consistent with African-American households typically having worse credit, and less income, than white households do.
31. Stegman, "Payday Lending." Interestingly, Flannery and Samolyk ("Payday Lending") note that while mature stores are located in zip codes with higher proportions of African-Americans, the lenders in their study typically locate their newer stores in zip codes with lower proportions of African-Americans and Hispanics.
32. Graves and Peterson, "Predatory Lending and the Military."
33. Morgan, "Defining and Detecting Predatory Lending"; Stegman, "Payday Lending."
34. In 2006, Congress enacted the Talent-Nelson Amendment to the John Warner National Defense Authorization Act of 2007. The amendment, also known as Section 670, is meant to regulate the terms of certain credit extensions, including payday loans, vehicle title loans, and refund anticipation loans, to active-duty service members and their dependents. See Department of Defense, "Report on Predatory Lending Practices," 50580, 50584.
35. Carrell and Zinman, "In Harm's Way?," 2805-40.
36. Brown and Cushman, "Compensation and Short-Term Credit Needs."
37. See Ernst, Farris, and King, "Quantifying the Economic Costs." Ernst et al. notes that this estimate is conservative because it includes only the direct costs of payday lending. The estimate does not include the costs associated with what they term "payday lending induced bankruptcies."
38. To our knowledge, proponents are silent on the actions by other consumers who pay the minimum monthly payment on their credit cards. Credit cards have a lower APR than payday loans or traditional installment loans, but paying the minimum monthly payment drastically extends the amount of time to pay off a credit card. See, for example, the calculator available at www.greenpath.com.
39. Proponents once advocated for a ban on the production, transportation, and sale of alcoholic beverages, which resulted in the Eighteenth Amendment to the US Constitution. These proponents mistakenly believed that these bans would then result in nearly zero levels of alcohol consumption.

40. Morgan and Strain, “Payday Holiday.”
41. *Ibid.* Morgan and Strain reported similar results for North Carolina.
42. Morgan, “Defining and Detecting Predatory Lending.”
43. Morse, “Payday Lenders,” 28–44.
44. Peterson, “Usury Laws and Consumer Credit”; Peterson and Falls, “Impact of a Ten Percent Usury Ceiling.”
45. Peterson and Falls, “Impact of a Ten Percent Usury Ceiling.”
46. Peterson, “Usury Laws and Consumer Credit.” Although credit card rates were subject to the interest rate cap, merchants accepting credit cards could mark up prices so that they could lend at the state-imposed interest rate.
47. Pawnbrokers typically charge a fee of 10 to 20 percent per month.
48. Collins and Sonstegaard, “Hey Buddy Can Ya’ Spare a Dime?”
49. Zinman, “Restricting Consumer Credit Access.”
50. *Ibid.* Adverse condition is defined as being unemployed or having a negative subjective assessment about one’s overall or future financial condition. Although Zinman’s results are consistent with the notion that payday lending is welfare enhancing rather than welfare destructive, he cautions that more research is needed in this area.
51. *Ibid.*, 547.
52. Bureau of Consumer Financial Protection, Payday Loans and Deposit Advance Products, 81 Fed. Reg. (July 22, 2016): 47863, 47871.
53. Morgan, “Defining and Detecting Predatory Lending.”
54. DeYoung and Phillips, “Payday Loan Pricing.”
55. After controlling for loan volume, Flannery and Samolyk also find that the economic and demographic conditions in the neighborhoods where the stores are located do not have much of an effect on profitability. Flannery and Samolyk, “Payday Lending.”
56. Huckstep, “Payday Lending,” 204.
57. Stegman and Faris, “Payday Lending.”
58. Huckstep, “Payday Lending.”
59. National Commission on Consumer Finance, *Consumer Credit in the United States*.
60. Smith (“Rethinking Usury Laws”) reports that state laws codified usury as charging interest over the legal maximum. In the early twentieth century, legal lending rates were typically 6 percent. Under the laws at the time, a lender was equally guilty of usury for charging 7 percent per year or charging 7 percent per month.
61. These movements included women’s suffrage, temperance, child worker laws, pensions for workers, and pure food and drug laws.
62. See Calder, *Financing the American Dream*, and Anderson, “Experts, Ideas, and Policy Changes,” for detailed descriptions of the Progressive era, the Russell Sage Foundation, and credit reform.
63. Carruthers, Guinnane, and Lee, “Bringing ‘Honest Capital,’” 393–418.
64. The Russell Sage foundation, as well as the Progressive Movement of the early twentieth century, placed considerable weight on the value of rigorous research to underpin social

- legislation. This emphasis extended to the setting of interest rates. The emphasis on the value of rigorous research has faded, but the rates from a hundred years earlier remain. For example, lacking the support of rigorous research, the Talent-Nelson Amendment and the national usury ceiling proposed by Senator Dick Durbin both propose keeping annual interest rate caps of 36 percent (i.e., 3 percent per month).
65. Hubachek, "Development of Regulatory Small Loan Laws," 108–45. Appendix C in *ibid.*, "Sixth Draft: General Form of Uniform Small Loan Law," distills all the work and thought on this topic into a model law. The language of the sixth draft grew to fill eight pages in twenty-five years: six pages that outline the model law and two pages that contain nineteen notes on various aspects of it.
 66. Michelson, *Consumer Finance*.
 67. Foster, "Personal Finance Business," 154–72.
 68. For this chapter, this history is not germane. The origin of the Uniform Small Loan Law, the origin of the 36 percent rate cap, and current state-mandated interest rate caps are much more important.
 69. Durkin et al., *Consumer Credit and the American Economy*.
 70. *Ibid.*
 71. One of the authors is currently researching the costs of installment loan production over time versus the income from installment loans of various sizes. The purpose of the project is to identify when installment lenders migrated away from loans less than a particular size (say, \$1,000).
 72. Community Financial Services Association of America, "About the Payday Advance Industry," retrieved October 27, 2016, <http://cfsaa.com/about-the-payday-advance-industry.aspx>.
 73. Bair, "Low-Cost Payday Loans."
 74. Caskey, "Payday Lending," 1–14.
 75. Stegman, "Payday Lending"; Bair, "Low-Cost Payday Loans," citing Stephens Inc., "Industry Report."
 76. The CFPB estimated that the number of payday lending stores operating in 2014 was 15,766. Bureau of Consumer Financial Protection, "Payday, Vehicle Title, and Certain High-Cost Installment Loans; Proposed Rule," 81 Fed. Reg. (July 22, 2016): 47864, 47871.
 77. Hecht, "Alternative Financial Services."
 78. Within a week in July 2009, the US House of Representatives held a hearing on "The Proposed Consumer Finance Protection Agency: Implications for Consumers and the FTC," and the US Senate held a hearing titled "Creating a Consumer Financial Protection Agency: A Cornerstone of America's New Economic Foundation." On July 21, 2010, the 848 pages of H.R. 4173 became Pub. L. 111-203, commonly called Dodd-Frank. See Law Librarians' Society of Washington, DC, "Dodd-Frank Wall Street Reform and Consumer Financial Protection Act: A Brief Legislative History with Links, Reports and Summaries."
 79. See Zywicki, "Consumer Financial Protection Bureau," 856–928, for a carefully detailed presentation of the implications of the "rush to regulate" approach manifested in this massive agency.
 80. One might be inclined to include online payday loans, but the focus in this chapter is on "brick-and-mortar lenders." One might also be inclined to include pawn loans or title loans. These transactions, however, are not loans in the traditional sense because the borrower has the right simply to exchange the good (or vehicle) for cash and walk away. Although the borrower has the option to redeem the proceeds for the pawned item, there is no recourse for the

- lender. In addition, credit cards might not be available to some consumers. Other consumers might have access to credit cards, but have no available credit remaining on their cards.
81. Foster, "Personal Finance Business."
 82. Rate ceilings were also graduated in many states in the 1930s.
 83. The careful reader will wonder why installment lenders operate in these states. Our conjecture is that dollar loan levels in these states are, on average, significantly higher than in states with higher interest rate caps.
 84. Because the principal is paid down each month, it is important to note that at a 36 percent APR, the dollar amount of interest paid on a \$1,000 twelve-month installment loan is \$206. That is, it is *not* the simple interest amount of \$1,000 times 0.36, or \$360. An APR of 61 percent results in an interest cost of \$360.
 85. The estimates come from Smith, "Recent Trends." Exhibit 7-16 of the NCCF report incorporates the cost data from 1964.
 86. Durkin, Elliehausen, and Hwang, "Rate Ceilings."
 87. *Ibid.*, table 9. These states are Texas, South Carolina, Illinois, Missouri, and Georgia.
 88. For the CFSA, see www.cfsaa.com and, for the CFED website, www.paydayloaninfo.org. Two other useful resources are at www.ncsl.org, which is provided by the National Conference of State Legislatures, and "Resource Guide: Protections from Predatory Short-Term Loans," from the CFED, cfed.org/assets/scorecard/2013/rg_PredatoryLending_2013.pdf. Data for Maine and Ohio are from Barth et al., "Do State Regulations Affect Payday Lender Concentration?" Data was gathered directly from each state's regulatory authorities.
 89. Compare CFED with Barth et al., "Do State Regulations Affect Payday Lender Concentration?"
 90. However, the website, paydayloaninfo.org, does not specify a limit for two states where it is unlikely that payday lending operates, Maine and Oregon, and does not specify a limit for two other states, Texas and Wyoming, where payday lending likely operates.
 91. A careful reader would notice that, to be useful in a mortgage, an APR would have to reflect when the borrower expects to repay the mortgage—something that the borrower cannot always predict. To make an intelligent mortgage loan decision, the borrower might need more than the APR or any other single number.
 92. Durkin and Elliehausen, *Truth in Lending*.
 93. Durkin and Elliehausen, "Assessing the Price of Short Term Credit."
 94. See Mors, *Consumer Credit Finance Charges*. We thank an anonymous reviewer for providing this discussion.
 95. Elliehausen and Lawrence, "Payday Advance Credit in America."
 96. Buch, Rhoda, and Talaga, "Usefulness of the APR." Buch et al. note similar difficulties in mortgage borrowers making comparisons in selecting mortgages based on APR.
 97. DeYoung and Phillips, "Payday Loan Pricing."
 98. To see how to calculate APR, go to www.moneyandhappiness.com/blog/?p=26.
 99. Tescher, "Letter to Mr. Robert E. Feldman."
 100. The monthly payment on a \$1,000 one-year installment loan with an APR of 36 percent is \$100.46, which means the total interest paid is \$205.55.
 101. The monthly payment on a \$200,000 thirty-year mortgage with an APR of 4 percent is \$954.83, which means the total interest paid is \$143,739. The monthly payment on a \$1,000

- one-year installment loan with an APR of 96 percent is \$132.70, which means the total interest paid is \$592.34.
102. Durkin, Elliehausen, and Hwang, "Rate Ceilings."
 103. As detailed in Michelman, *Consumer Finance*; National Commission on Consumer Finance, *Consumer Credit in the United States*; Durkin, Elliehausen, Staten, and Zywicki, *Consumer Credit and the American Economy*; and Durkin, Elliehausen, and Hwang, "Rate Ceilings."
 104. Durkin, Elliehausen, and Hwang, "Rate Ceilings"; National Commission on Consumer Finance, *Consumer Credit in the United States*.
 105. Michelman, *Consumer Finance*.
 106. Quote from Glenn, Brandt, and Andrews, *Russell Sage Foundation 1907–1946*. Remedial Loan Societies in the early 1900s exemplified the principle of "philanthropy and 6 percent" by lending small amounts of money at rates high enough to cover their operating costs and yield a "fair" return on capital invested. Given the number of illegal lenders operating at the time, the Remedial Loan Societies obviously could not supply all demand for small loans.
 107. Anderson, "Experts, Ideas, and Policy Changes."
 108. Hubachek, "Development of Regulatory Small Loan Laws," app. C, n14.
 109. National Commission on Consumer Finance, *Consumer Credit in the United States*.
 110. One might be inclined to include online payday loans, but the borrower here prefers to deal with a lender in the flesh. One might also be inclined to include pawn loans or title loans. These transactions, however, are not traditional loans because they are nonrecourse—that is, the borrower has the right simply to exchange the good (or vehicle) for cash and walk away.
 111. Durkin et al., *Consumer Credit and the American Economy*, 491.
 112. See National Conference of State Legislatures, Payday Lending State Statutes. For more information, see Consumer Federation of America, "Legal Status of Payday Loans by State."

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