Payday Lending and Public Policy:

What Elected Officials Should Know

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I. Introduction

The emerging payday loan industry is one of the fastest growing segments in the broader consumer financial services market. One estimate suggests that the number of payday loan offices nationwide increased from roughly 300 in 1992 to nearly 10,000 by 2001 (Brown, Findlay, Lehman, Maloney and Meehan, 2004). The Community Financial Services Association of America (CFSA), a trade group representing the payday loan industry, currently reports on its website (www.cfsa.net) that there are over 15,000 payday advance locations nationwide extending roughly $25 billion in short-term credit annually.

In Indiana, trends appear to mirror the nationwide growth in this industry. According to the Indiana Department of Financial Institutions (2006), there are a total of 606 licensed payday loan locations in the state. Of those, just 30, or less than 5 percent, were licensed and operational before 1996, an over twenty-fold increase in payday loan storefront locations in the last decade. In my city of Marion, Indiana, the DFI report identifies at least seven payday loan firms operating nine different storefront locations. Four of those locations, or roughly half of the shops in the city, have been operational only since 2004. Only one location was in operation prior to 1996. Clearly, the demand for short-term credit is booming, and cash advance firms have responded rapidly to meet this market demand.

At the same time, and despite (or perhaps because of) its infancy, payday lending is becoming one of the most heavily regulated segments of the financial services industry. Thirty-nine states, including Indiana, permit regulated payday loan operations, limiting fees that can be charged, setting maximum loan amounts per borrower, limiting the term of loans, and setting limits on the number of times a customer may access multiple or repeated payday loans in a given period. Eleven states explicitly outlaw payday loan operations altogether[1] (although payday lending is a de facto reality in virtually all states due to the internet and telephone). Currently, payday loan operations are regulated on a state-by-state basis in compliance with broad federal guidelines set by, among others, the Truth in Lending Act and the Federal Deposit Insurance Act (Brown et al., 2004; Elliehausen and Lawrence, 2001). However, current trends suggest that federal regulation targeting the payday lending industry could be forthcoming, and state legislatures continue to debate proposals for further regulating or even banning the practice altogether.

Given this tenuous environment, it is important for elected officials to have a better understanding of the economics of payday lending, the markets in which these firms operate, and the consumers they serve. The general consensus appears to be that payday lending is a practice that offers few benefits and may do harm to unwitting borrowers, thus necessitating government intervention and regulation. This paper hopes to counter that view by providing an analysis of the payday lending industry, its history and market characteristics, the profile of its “typical” borrower, numerous criticisms of the industry and, perhaps most importantly, the unintended consequences of policy interventions into this industry that are often overlooked. The message to state officials is: beware of the

law of unintended consequences; well-intended policies may end up doing more harm than good for the people you hope to assist.

II. What Are Payday Loans? An Overview

Payday lending, also known as a "payday advance," "cash advance" or "deferred deposit" loan, is a short-term two- to four-week loan backed by a postdated personal check that a borrower agrees to cover with sufficient funds out of his or her next paycheck. The typical fee for this service is ten or fifteen dollars per $100 borrowed. In Indiana, the finance charge is regulated to 15 percent of the first $250, 13 percent of the amount between $250 and $400, and 10 percent of any amount between $400 and $500, with a maximum payday loan limit of $500 and a minimum term of 14 days (Indiana Code 24-4.5-7).

The process begins when the borrower issues a postdated check written for an amount equal to the sum of the desired loan plus the related fees. The payday lender then issues the borrower a loan equal to the postdated check net of the fee and holds the check until the agreed-upon date. The process ends when the lender cashes the postdated check for payment covered by the borrower's most recent payday deposit, or when the borrower redeems the check directly from the payday lender by paying the loan amount plus the finance charge.

To date, Elliehausen and Lawrence (2001), Stegman and Faris (2003), Brown et al. (2004), and Hanson and Morgan (2005) offer the most comprehensive studies of the nationwide payday lending industry. Their work indicates that payday loans vary in size from $100 to $500, carry an average fee between $15 and $20 per every $100 borrowed, and have an average duration of between 14 and 30 days.

Although a recent phenomenon, the historical seeds of the payday lending industry were planted in the late 19th century. Before organized consumer credit, there were five major sources of consumer loans: pawnbrokers, black market small-loan lenders, retailers offering "store credit," friends and family, and mortgage lenders. Americans had few places to obtain small amounts of cash in emergencies. Pawnbrokers emerged as the "poor man's banker" (Brown et al., 2004).

The early and mid-1990's saw a boom in payday lending. At the beginning of the 1990s, payday lending was primarily the domain of small, independent check-cashing outlets and pawnshops. These firms specialized in making loans to borrowers with limited access to alternative credit. The number of payday lenders has surged in recent years as the high level of consumer demand for short-term, small-denomination credit has brought more suppliers into the marketplace.

Various factors have given rise to the cash advance industry. Retailers moved away from installment loans and store credit, opting instead for credit cards (which some payday borrowers cannot or will not access), leading to a rise in demand for payday loans. On the supply side, conventional lenders, such as banks and credit unions, began

to specialize in larger secured loans such as vehicle lending and home mortgages, choosing to avoid the smaller loan market due to its higher cost per dollar loaned.[2]

Aside from each other, payday loan firms appear to compete most vigorously with pawn shops (Hanson and Morgan, 2005). In fact, current trends indicate that pawn brokers are branching out and offering payday lending services in addition to, or in lieu of, collateral-based pawning. Additionally, payday lenders compete with the informal small-loan market which generally lies just beneath the level of pawn shops, usually consisting of unsecured loans from family, friends, or "acquaintances." However, this informal sector (i.e., the black market) is not governed by contract law or enforceable property rights, making such markets potential grounds for abuse between borrowers and lenders. Payday lending, then, has come to fill a market niche in the consumer finance industry between the informal sector, on the one hand, and conventional but less flexible consumer loan products on the other (Brown et al., 2004).

III. Who Would Use Payday Loans and Why?

Given the relatively high cost of a cash advance loan (annual percentage yields on these loans range in the triple-digits, as discussed below), many readers may recoil at the notion of using payday loans. In order to understand the growing popularity of the cash advance industry, it is helpful to have a profile of the "typical" payday loan consumer and, perhaps more importantly, examples of the uses to which payday loans are often put. Again, the recent but limited research on this industry offers some guidelines.

Studies by Elliehausen and Lawrence (2001)[3] and Stegman and Faris (2003) reveal certain attributes about payday lending consumers in terms of their income, employment, age, marital status, race and gender, education level, and credit status. Some of these characteristics distinguish payday loan consumers from the broader population. Yet, the striking conclusion is how mainstream payday loan consumers seem to be.

Income

According to Elliehausen and Lawrence (2001), the majority of payday lending customers have moderate family incomes between $25,000 and $50,000 annually (51.5 percent). A plurality of these consumers has annual family incomes below $25,000 (23 percent), while another large minority has family incomes in excess of $50,000 annually (25.4 percent). Based upon this study, the typical payday loan consumer might have annual family income ranging from $25,000 (below the national median) to $50,000 (above the national median). Most notably, the market for payday loans does not appear to consist of the chronically poor or "underclass" as is commonly perceived. And, perhaps because of the relatively high variation in incomes among payday loan consumers, findings by Stegman and Faris (2003) suggest that income alone is not a reliable predictor of the use of payday lending. Other factors play a more significant role.

Employment

Because payday lending firms typically require proof of employment before extending a cash advance, almost all payday lending consumers are employed. Although no definitive studies have been done to detect the employment status of payday loan customers, we can conclude that the vast majority have a job. Indeed, the idea of receiving a "payday" loan implies that one is gainfully employed and receives a regular paycheck. Stegman and Faris (2003) find that households with no employed adult are much less likely to use payday lending services.

Age

The majority of payday loan consumers are young adults and typically in the early stages of the financial life cycle. This is consistent with the moderate incomes of most payday loan customers indicated above. Ellihausen and Lawrence (2001) find that 36.4 percent of payday advance customers are younger than 35 years of age, and nearly 70 percent are younger than 45 years of age. Only 10 percent of payday loan consumers are age 55 or over. The payday lending market is dominated by younger consumers, and the use of this type of service tends to decline with age. However, the same can be said of any other type of consumer loan product, so it is not clear that age is able to distinguish payday loan consumers from consumers of other retail lending services. Home mortgage loans, vehicle loans, and loans on appliances and other personal property are all likely to be more common among young and middle-aged families, and will tend to decline with age as income rises and the need for debt declines.[4]

Marital Status

The majority of payday loan customers, nearly 60 percent, are married or living with a partner, according to Elliehausen and Lawrence (2001). This compares similarly with the general adult population. A minority of payday loan users (23 percent) are divorced or separated. This is a slightly higher proportion than prevails in the general adult population (13.8 percent). Divorce and/or separation could be an underlying factor explaining the demand for payday advance services among certain groups, particularly divorced or separated women who may have few other credit alternatives.

Race and Gender

One of the weaknesses in the payday lending research to date is the absence of a definitive study on the breakdown of payday loan consumers by race, ethnic group and gender. However, race seems to play a role in explaining the demand for payday lending services, as suggested by Stegman and Faris (2003). Their study of the North Carolina market indicates that the likelihood of using a payday lender goes up significantly for African American households. In fact, in their study, this is one of the top three predictors of the probability that a household has used a payday lending service in the past. They find the odds that an African American household has used a payday lending service are over 2-to-1.

This is consistent with other research suggesting that African American households retain smaller balances in their checking accounts relative to whites, and that African American households have significantly less wealth, such as financial assets, to draw upon during a financial emergency (Chiteji and Stafford, 1999). This could explain why African American households are more likely to use payday lending services: they may be the only alternative available in emergency situations when immediate cash is needed.

One caveat is in order, here. Critics have charged that payday loan firms "target" African American consumers as a means of exploiting them. One recent and well-touted study, analyzing only the North Carolina payday loan market, popularized the notion that payday loan firms intentionally locate in census tracts with a higher proportion of African Americans (King, Li, Davis and Ernst, 2005). However, upon closer examination, this study was found to be plagued with numerous errors that have since called into question the authors' conclusions (Lehman, 2005b; Saltes, 2005). In particular, the authors possessed no data on the racial composition of actual customers of the payday loan stores under investigation, and likely confused correlation with causation in their analysis. To date, no credible research has been able to demonstrate that race is a factor in determining payday loan store location, and the charges of critics that payday loan firms "target" minorities should be viewed with great skepticism.

Educational Attainment

Most research indicates that use of payday lending services declines with educational attainment. According to the study by Elliehausen and Lawrence (2001), 38.3 percent of payday lending customers have only a high school diploma, 36.1 percent have some college, and 19.4 percent have at least a four-year college degree. Payday loan customers are thus distributed in the lower and middle levels of educational attainment. However, only a small proportion of payday loan customers have less than a high school diploma (6.2 percent) according to Elliehausen and Lawrence, and Stegman and Faris (2003) find that high school dropouts are significantly less likely than any other group to use payday lending services. This could reflect underlying factors germane to this group, such as the higher levels of unemployment experienced by high school dropouts. From the available research, we can conclude that payday loan consumers typically have some modest level of education, perhaps some college or, in limited instances, even a four-year degree. Again, this finding suggests that payday loan consumers do not differ greatly from the general population.

Credit Status and Related Factors

Users of payday lending services may exhibit below-average indicators of creditworthiness. In the survey by Elliehausen and Lawrence (2001), over 60 percent of users of payday lending services responded that they had refrained from using a credit card in the past year because doing so would have pushed them beyond their approved credit limit. A significant proportion (18.5 percent) of payday loan customers have consumer debt payment-to-income ratios of 30 percent or higher, which is well above the average for all adults in this category (5.3 percent). A large majority of payday loan

customers (73 percent) report having been turned down for credit or not awarded the amount of credit they applied for within the previous five years. And, over 15 percent of payday loan users have filed for bankruptcy in the previous five years, well above the proportion of all adults who have done so (3.7 percent).

In the study by Stegman and Faris (2003), the strongest predictors of the likelihood of using a payday advance service were related to indicators of creditworthiness. Survey respondents who had worked with a credit counselor or who had one or more bounced checks (overdrafts) within the previous five years were significantly more likely to use payday lending services than other groups. Additionally, Stegman and Faris find that the single strongest predictor of the frequency of use of payday lending services is whether or not the respondent had been called by a collection agency for overdue bills. Households that have received collection calls on overdue bills were more likely to use payday lending services than those who had not received collection calls. This suggests that when households are pressured for past due payments on existing balances due, payday advance alternatives may be a viable and useful outlet that helps them overcome short-term financial emergencies or bounced checks. Indeed, additional research comparing check overdraft fees with the finance charges on payday loans suggests that payday loans are a less costly alternative (Lehman, 2005a).

Payday Loans and Consumer Decision Making

Contrary to prevailing opinions about the payday lending industry, consumers of payday loans may be quite rational in using this financial service given the alternatives they face. While information as to why people want to take out a small loan prior to payday is somewhat limited, a few common themes are evident in the available research (Caskey, 2003).

Despite annualized interest rates that are high, consumers sometimes choose payday loans to avoid tapping into savings. Often the borrowers are seeking only to solve an immediate emergency need for about $200, and, as explained above, banks typically do not make such small closed-end loans. Some research speculates that borrowers may prefer self-imposing financial discipline by obtaining a payday loan, forcing themselves to avoid revolving credit or to avoid the temptation to draw down a savings nest egg (Elliehausen and Lawrence, 2001). Others have postulated poor budgeting habits. Some households may have "too much month left at the end of their income," and a payday loan is a quick and easy way to stem the tide until payday (Caskey, 2002).

Even consumers who can access alternative sources of credit have opted for the relative convenience and speed of a payday loan. The Elliehausen and Lawrence (2001) survey of payday loan consumers found more than half (59 percent) identified the most important reason for choosing a payday loan over another source was "quick, easy process, fast approval, less paper work." About 10 percent chose a payday loan because of a convenient location. Interestingly, about 10 percent identified privacy as a critical and most important reason.

One alternative for consumers facing a cash shortfall is to seek a loan from family or friends. However, borrowers often prefer to obtain the cash advance from a payday lender rather than reveal their financial situation to friends or family. They may be ashamed of their current financial circumstance, or may simply prefer the relative anonymity of a payday loan over a loan from a family member. Additionally, some borrowers may have exhausted their access to such informal alternatives (Caskey, 2002).

For many, it is a choice of taking out a payday loan, going without some need in an emergency, or confronting more expensive options. Consumers who may not have access to other forms of credit, nonetheless may have other "alternatives." For example, they can knowingly write a bad check and incur bank and check recipients' returned-check fees (which could together amount to or exceed $50 per occurrence in 2004), while also seeing their credit rating eroded. According to Caskey (2002), many banks have begun to offer a payday-loan-like product described as "Bounce Protection" or "Automated Overdraft Privilege." This credit product effectively functions like a line of credit attached to a checking account, but the banks offering the service claim that it is not a credit product, and thus do not identify the cost as a finance charge, just an overdraft fee. The overdraft fee is much higher than what the banks would earn in finance charges on a line of credit, and they presumably market the product to borrowers whose credit histories make them ineligible for credit lines. A borrower might, for example, write a check for $100 drawn on insufficient funds that the bank honors, for a $20 overdraft fee. If the borrower has two weeks to return the account to a positive balance, one could argue that the effective cost of this credit, expressed as an APR is 520% (Caskey).[5] As indicated above, when compared to an overdraft charge, the finance charge on a payday loan may be a less costly option (Lehman, 2005a).

Alternatively, consumers can opt to forego the product or service they need. In many cases, consumers need quick cash to pay for automobile repairs. Given the modest incomes of some payday loan customers, they may own only one automobile, and this automobile may be the single means of transportation to and from their place of employment. Foregoing the auto repair may jeopardize their employment, and a payday loan could provide the only means available to prevent a domino of otherwise unavoidable and undesirable events. Such a scenario is not uncommon, and helps to illustrate the demand for, as well as the rationality of, payday loans.

In other examples, the foregone service may be a utility bill. The costs of reconnecting utility services can be significant. Brown et al. (2004) provide examples that illustrate the range of such fees:

Phone (e.g., $12 to reconnect in Illinois);
Cable (e.g., $5 late penalty per month in Virginia);
Natural gas (e.g., $78 to reconnect in Maryland);
Electric (e.g., $37.80 daytime reconnect fee or $73.83 at night, in North Carolina); and
Water/sanitary services (e.g., $25 in Texas).

In addition to the above illustrative re-connect fees, some states permit their regulated utilities to collect deposit fees from residential borrowers with histories of non-payment.

For example, in Illinois, if a borrower makes more than four late payments in one year, gas or electric utilities may require deposits of as much as 1/6th of the estimated annual bill. For water and sewer services in the same state, the deposit amount may be up to 1/3 of the estimated annual charges (Brown et al., 2005). Against these requirements and costly alternatives, the decision to secure a payday loan appears more reasonable, and could easily be less costly than other alternatives.

IV. The Objections to Payday Lending

The critics of the payday lending industry have raised several objections to cash advance loans, and, on the basis of these objections, pushed for further industry regulation or for banning the practice altogether. While these objections bear consideration, they are often a knee-jerk response to a relatively new consumer finance product. Furthermore, many of the critics who claim to defend the interests of payday loan consumers neglect the potential damage done to these consumers from proposed regulations. It is important, then, to consider not only the objections to payday lending, but also the alternatives and the unintended consequences of misguided policies.

"Usurious" Rates of Interest

The most common objection to payday loans is that they carry a high (some would say "usurious") annual rate of interest. That is, on an annualized basis, the finance charge on the payday loan relative to the small amount borrowed can easily compute to a triple-digit interest rate. Looked at from this perspective, the cost of a payday loan appears extreme. This has given rise to calls for rate regulation and caps on the finance charges that can be levied for payday loans. For example, in Indiana, the finance charge is regulated to 15 percent of the first $250, 13 percent of the amount between $250 and $400, and 10 percent of any amount between $400 and $500, with a maximum payday loan limit of $500 and a minimum loan term of 14 days (Indiana Code 24-4.5-7). So, for instance, a $250 14-day cash advance loan would carry a maximum fee of $37.50 under current law ($250 x 0.15). This computes to an annual percentage rate (APR) of interest equal to 390 percent[6] which, for some critics, is evidence of usury.

However, from an economic perspective, this viewpoint is flawed for several reasons. First, a relatively high price for any good or service is not alone an argument that markets have failed or that harm has been done. High prices may be a symptom of monopoly in rare instances, but this certainly does not appear to be the case in the payday loan industry in light of the ease of market entry and the proliferation of competition in this market in the last decade. Prices in competitive markets, including competitive small-loan markets, are set by the prevailing conditions of supply and demand. Given the strong and increasing demand for small loans for reasons documented above, combined with the tremendous growth in the number of payday loan outlets, there would certainly appear to be no market failure in this industry (i.e., competition appears to be thriving).

Second, because payday lending establishments often deal with a high-risk clientele as documented by Stegman and Faris (2003), the effective annual interest rates charged on

these types of small loans are going to reflect increased risk. Available data on defaults suggests that unpaid obligations to payday lenders amount to between 10 and 20 percent of the annual finance charges these lenders levy (Caskey, 2002).[7] The entrepreneur in this high-risk industry must find a way to recover their investment and earn a positive rate of return. They are drawing scarce financial resources out of some other line of investment, and are committing these resources to a high-risk venture in making unsecured loans to borrowers who may have poor credit histories. Because the risk may be higher, the risk premium on the loan would naturally be higher. And, the level of this risk premium, again, will be set by the level of competition and the conditions of supply and demand.

Third, the fixed labor and capital costs associated with offering and underwriting a small loan are similar to offering and underwriting a larger loan. With a larger loan principle, the lender can cover costs and earn a profit by charging a lower interest rate over a lengthier period of time. Small-principle short-term loans, on the other hand, while costing roughly the same to supply, cannot charge equally low rates of interest and expect to cover costs. (As explained above, this is one of the reasons that conventional lenders such as banks and credit unions avoid making small loans.) By their very nature and quite apart from the risk associated with them, small-balance short-term payday loans must charge a higher rate of return to induce profit-seeking entrepreneurs to provide them.

Finally, although lenders are required by law to disclose the APR at the time of the loan, it may not be a concern to the borrower. In all likelihood, the “effective APR” is irrelevant to the borrower. According to Brown et al. (2004), few borrowers are able to recall the APR of their cash advance loan. The real price signal to which the borrower responds is the flat fee that is charged to hold the postdated check. If the value attached by the borrower to the immediate cash advance exceeds the value of the principle plus the fee two or four weeks hence, then the borrower will undertake the transaction and expect to benefit as a result.

Economic values are subjective. In the case of payday lending, time preferences, a form of valuation between present and future goods, are also subjective. Those with relatively high time preferences are going to be willing to pay more in the future to obtain goods (or cash) in the present than those with relatively low time preferences, all else equal. In this sense, then, there is no such thing as an "excessively high" finance charge. It is entirely subjective to each voluntary participant in the transaction.

In sum, then, justification for further rate regulation or banning of payday lending cannot be supported on economic grounds. Indeed, to the contrary, as economists well understand, heavy regulation stifles entry into these markets, and thus restrains the very competitive forces that serve to bring prices (rates) down naturally. Hanson and Morgan (2005) find that more payday lenders and pawnshops per capita correlate with lower payday loan rates and fees, suggesting that competition is welfare-enhancing in these markets.

Additionally, legislated price ceilings and caps are a prescription for disaster in any market because, to the extent that they are binding, they distort prices and throw supply and demand into permanent disequilibrium. To put it less technically, state regulations that hold finance charges on payday loans below the market-clearing level will lead inevitably to an excess of demand over supply, creating shortages in the small loan market and preventing marginal borrowers from obtaining credit in emergency circumstances.

Unfortunately, Indiana has some experience with this type of scenario. In 2001, the State Attorney General and the Indiana Supreme Court required payday loan firms to limit finance charges to no more than a 72 percent APR to conform to Indiana's loansharking statute (Indiana Department of Financial Institutions, 2001). Subsequent to that date, the number of licensed payday loan outlets in the state of Indiana dropped precipitously according to the DFI, reducing competition in the small loan and pawn markets in 2001 and 2002. In 2002, the state legislature revised the laws governing small loans and raised the finance charge ceiling to its current higher level as expressed in Indiana Code 24-4.5-7, leading to a revival of competition in payday lending in the state.[8]

If the intent is to make legal credit available to the widest possible number of people at the lowest possible price, then critics who argue for more government regulation due to the perceived high price of payday loans are acting at cross purposes with their stated goals. Proposals for tightened rate regulation in this industry will not only reduce competition, but will distort markets, reduce efficiency in credit allocation, and make circumstances more difficult for the very consumers who depend critically upon payday lending in emergency situations.

Predatory Lending and Chronic Borrowing

Another objection to payday lending is that it causes households to fall into a trap of perpetual borrowing, becoming chronically dependent upon payday loans. Critics contend that payday lending impoverishes poor households by encouraging chronic borrowing from paycheck to paycheck, putting them deeper in debt and perhaps forcing bankruptcy. Payday lenders may offer to "roll over" the initial debt by asking the borrower to pay an additional fee to defer the loan or to write a second postdated check in lieu of the original. This "predatory" lending is seen by critics as a way for payday lending firms to increase profits and keep customers in chronic dependency on payday loans (Stegman and Faris, 2003). Although this is a valid concern, both theory and evidence tell us to be skeptical of this argument.

First, the allegation that payday lending "causes" chronic or habitual borrowing may ignore the old adage that "correlation does not equal causation." As indicated above, payday loans appeal to a clientele that may face numerous financial difficulties quite independent of the payday lending industry itself. Some of these households have failed to establish credit, may have poor credit histories, may pay their bills slowly, frequently bounce checks, frequently change jobs, or may relocate often. In short, it is true that

some payday loan consumers are the type of people who are going to be frequently short of cash and who will borrow "chronically" when given the opportunity. Because payday lending institutions provide them with this opportunity to borrow when other institutions deny credit does not mean that payday lenders cause this behavior. They simply provide an opportunity for this behavior to be exhibited more often than otherwise, and bear the added risk as a result.

In any case, as the research by Elliehausen and Lawrence (2001) indicates, the vast majority of payday loan customers pay on time, and over half of customers' longest consecutive sequence of advances was less than a month. More importantly, the "invisible hand" of the market is much better than the "visible fist" of government in restraining excessive payday loan rollovers:

It is not in the best interest of either consumers or payday lenders to permit an excessive number of payday loan rollovers. By their very acceptance in the marketplace, consumers have signaled comfort with the benefits of payday loans. Although payday loans are appropriate for short-term use, consumers with sufficient credit histories and financial wherewithal are likely to pursue other options for longer-term loans. In other cases, consumers may simply not have a choice for an alternative loan. Additionally, lenders too, are compelled by market discipline. Because their loans are unsecured, payday lenders are less likely than secured lenders to make loans they believe will not be repaid from the borrower's cash flow (Brown et al., 2004, p. 8; italics added).

Additionally, the same allegation of chronic borrowing can and has been used to criticize other forms of consumer debt. Credit cards are alleged to "trap" users in a cycle of revolving debt (perhaps one reason some borrowers prefer payday loans even when credit cards are available). Yet, because of their long history and demonstrated convenience, credit cards are socially accepted forms of consumer credit, and do not elicit the shrill objections often heard against payday lending. The same could be said of revolving lines of home mortgage credit frequently used by homeowners to tap the equity in their homes whenever they believe real estate prices are appreciating. Default on such lines of credit, combined with misjudgments about the real estate market, could potentially cost borrowers their home, yet rarely do we hear allegations that such forms of credit "cause" debt traps. Thus, it is not clear how payday loans differ from these other alternatives in their potential to lead to chronic borrowing, other than that they have smaller balances over shorter terms, attributes that would seem to make them more attractive in the eyes of critics.

Finally, the research to date does not demonstrate that payday lending is "predatory" or that it leads to excessive delinquency among borrowers. Morgan and Hanson (2005) define predatory lending as a welfare-reducing provision of credit undertaken by borrowers who are deluded or deceived about their future income prospects. That is, predatory lending is said to occur when borrowers are encouraged by lenders to overborrow relative to their future income levels and their ability to repay. Morgan and Hanson test the theory that payday lending is predatory by comparing the delinquency rates between states that prohibit payday lending, states that heavily regulate payday

lending, and states that lightly regulate payday lending. Contrary to conventional wisdom among the critics of payday lending, they do not find that payday lending is predatory:

> Our findings seem mostly inconsistent with the hypothesis of predatory lending in states with higher payday limits and easier foreclosure. We do find that households with uncertain income (potential prey) in payday states have higher debt, but not higher delinquency. Just the opposite, in fact; households with uncertain income who live in states with unlimited payday loans tend to have slightly lower delinquency rates and they are less likely to report being credit constrained (i.e., denied credit or too discouraged to apply) (Morgan and Hanson, 2005, p. 4; italics in original).

V. Conclusion

The message is simple: policymakers and critics of the payday loan industry must become more informed about these markets, and must be much more cautious in their advocacy for further regulating or banning the practice lest they do harm to the consumers they ostensibly seek to protect. The recent success of the payday loan industry is a testament to the ability of markets to adapt to rising demand for new and untried methods of consumer finance provided government regulations do not corrupt the process. The "typical" payday loan customer does not differ greatly from the average American consumer, and almost always has a legitimate reason for using payday loans to cover an emergency cash shortfall.

Payday lending has come to fill a market niche in the consumer finance industry between the informal sector and conventional but less flexible consumer loan products. Preventing or limiting the use of payday loan services only encourages borrowers to seek out and utilize less attractive alternatives (such as informal or "black" markets) that put the borrower in an even weaker financial position. Further regulation or outright banning of payday lending has the adverse and unintended consequence of reducing credit options for those who may have few alternatives to begin with. In an age where the "democratization of credit" has been widely celebrated due to new technology, it is unwise to single out and restrict relatively new forms of credit. You do not help marginal borrowers by looking at their list of available options and then eliminating the one they actually choose.

Finally, as the evidence indicates, the arguments by payday loan critics are largely unfounded and their policy proposals misguided. If there is true concern about the high finance charges on payday loans, the best method of bringing them down is to repeal the regulations on payday lending that restrict competition and market entry. Rather than preventing or discouraging the proliferation of payday loan outlets, policymakers should instead make law that encourages an open and level playing field in the small loan market, permitting competition to put downward pressure on rates and fees.

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[1] Payday loans are currently not permitted under state law in Connecticut, Georgia, Maine, Maryland, Massachusetts, New Jersey, New York, North Carolina, Pennsylvania, Vermont, and West Virginia (Brown et al., 2004).

[2] The manpower and paper processing costs of issuing a $200, 30-day small loan are nearly identical to issuing a $5,000, unsecured 24-month loan. Whereas the former offers comparatively little revenue at the typical bank rate of interest, the latter offers significantly greater revenues relative to cost. Most conventional financial institutions, therefore, have chosen to avoid the small-loan market in favor of larger more profitable loans.

[3] The sample used in the Elliehausen and Lawrence study (2001) is comprised only of customers of payday lenders belonging to the CFSA trade association. CFSA members made up roughly half of all payday lenders at the time of the survey (year end 2000), and CFSA members are among the largest payday lenders. Because of these distinctions, there are concerns that the Elliehausen and Lawrence survey may not be representative. In addition, the survey is likely plagued by non-response bias. That is, many of the payday loan customers surveyed refused to respond, and if the non-responders are significantly different than those who chose to respond to the survey, the survey results may be biased. However, despite these weaknesses, the Elliehausen and Lawrence study remains one of the most thorough studies of payday loan customers to date.

[4] This is consistent with the life-cycle theory of income and expenditure which predicts that the consumption patterns of households are fairly stable over their lifetimes. That is, households will tend to spend and consume at similar levels across their lifetime, borrowing to do so in their early years when income is low,

and saving or paying down debt (rather than increasing spending) in their later years when income is higher (Ando and Modigliani, 1963; Friedman, 1957).

[5] $20 equals 20 percent of the $100 bounced check. This 20 percent multiplied by the number of two-week (fourteen-day) periods annually equals a 520 percent APR.

[6] $37.50 in finance charges divided by $250 in loan principle equals 15 percent interest for 14 days (two weeks). 15 percent multiplied by 26 two-week periods per year equals a 390 percent APR.

[7] On the other hand, and somewhat surprisingly, the Elliehausen and Lawrence survey (2001) reports that over 75 percent of payday borrowers repay their loans on time. Of the remainder who do not pay on time, most are late only once.

[8] To the extent that the current caps on payday loans in the state of Indiana are above the market-clearing level for these loans, the caps are benign and have no adverse impact. However, we cannot confidently conclude, based upon research to date, whether these caps are or are not binding at their current levels.