

When and Why Usury Should be Prohibited

Robert Mayer

Received: 22 February 2012 / Accepted: 4 September 2012
© Springer Science+Business Media B.V. 2012

Abstract Usury ceilings seem indefensible. Their opponents insist these caps harm the consumers they are intended to help. Low ceilings are said to prevent the least advantaged agents from accessing legal credit and drive them into the black market, where prices are higher and collection methods are harsher. But in this paper, I challenge these arguments and show that the benefits of interest-rate limitations in the most expensive credit markets clearly outweigh the costs. The test case is payday lending. Deregulated pricing in this market produces negative externalities that justify usury restrictions. Unless prices are capped, the more solvent majority of borrowers is compelled to cross-subsidize the least solvent debtors, who have a high rate of default. Rationing the riskiest debtors out of this market by means of a moderate usury cap puts an end to this unfairness and produces fewer bad consequences than the advocates of deregulated pricing recognize. I argue that only an extreme principle like maximizing the minimum could justify a free market in payday credit.

Keywords Credit · Interest rate · Just price · Loan shark · Payday lending · Usury

Introduction

The concept of usury seems outmoded. It implies there is some rate of interest that is too high and that it would be wrong to charge, either because the law prohibits one from

charging this rate or because charging this rate would be unfair even when legal. To determine what this wrongful rate of interest requires us to calculate a just price for the rental of money, which may seem like a hopeless task. A fair price for credit is whatever someone is willing to pay, we might think, and that varies enormously. Usury is a relic, it would seem, some superstition from a darker age.

But, curiously, this superstition refuses to die. It has been attacked for centuries by advocates of *laissez-faire*, yet religions still condemn usury and governments still proscribe it. In the United States, where state governments are permitted to establish interest-rate ceilings in many credit markets, only six out of 50 states have completely deregulated prices for the most expensive lending product, the payday loan. The other 44 states, plus the District of Columbia, impose a price cap in this market and, with two exceptions, these caps are binding. They do block some voluntary exchanges. In more than a dozen states, the ceilings are so low that payday lending is infeasible in the legal market.¹ The prohibition of usury therefore endures. In recent years, it has even become more stringent in many states. Jurisdictions that did not cap prices for payday loans before have chosen to do so now, and jurisdictions that did cap prices already have lowered them still further.² Despite vociferous objections from advocates of deregulation, legislators and voters in all but a handful of states continue to adhere to the idea that it is the proper business of

R. Mayer (✉)
Political Science Department, Loyola University Chicago,
1032 W. Sheridan Rd., Chicago, IL 60660, USA
e-mail: rmayer@luc.edu

¹ On the state laws that regulate payday lending see the Consumer Federation of America's "Payday Loan Consumer Information" at <http://www.paydayloaninfo.org/state-information>.

² Since 2000, price ceilings in the market for payday loans have been imposed or reduced in Arizona, Arkansas, Colorado, the District of Columbia, Florida, Georgia, Illinois, Montana, New Hampshire, New Mexico, North Carolina, Ohio, and Oregon.

government to enforce a price threshold above which willing debtors and lenders may not transact.

In “Money Does Not Grow on Trees: An Argument for Usury,” Labat and Block (2012) state the case against price-control laws in any credit market, including the market for payday loans. Lenders should be allowed to charge whatever borrowers freely agree to pay. The authors try to show that price-setting by government in credit markets, even the most expensive ones, is both unfair and has bad consequences, especially for the poor. They conclude that

loan agreements, at *any* interest rate, are part and parcel of freedom. The market, namely individuals, should be allowed to decide appropriate interest rates and assume all risks of their acts. If others do not wish to participate in those acts, they are not forced to, but should not be allowed to prevent others from utilizing their right to free trade, certainly including the exchange of money now in return for money later (Labat and Block 2012, p. 387).

This is a familiar libertarian argument (Baker and Breitenstein 2010; Mangu-Ward 2009).

This paper, however, rebuts the arguments of Labat and Block and tries to construct a better justification for imposing a usury statute, at least in the market for payday loans. In many credit markets, I readily concede, price-control laws are unnecessary and counterproductive. The government has no business setting prices for commercial loans, home mortgages, auto loans, and many other lending products. But credit markets do vary. The payday loan market is the most expensive credit market and it operates in a distinctive way. When fees are not capped, consumers pay higher prices in the legal market and the default rate increases. The more solvent and responsible borrowers who make use of this product are unfairly burdened because, when prices are deregulated, lenders extend credit to riskier applicants, whose rate of default is higher. These losses must be covered by the more solvent, who are charged inflated prices that, in turn, make it more difficult for them to pay back these expensive debts. In this credit market, price deregulation is unfair to and has bad consequences for the more deserving fraction of a struggling population. These credit-constrained consumers are made worse off so that lenders, who are better off to begin with, can extend credit to, and try to profit from, less solvent and riskier wage-earners, many of whom will default on their loans. As I will try to show, price deregulation in the market for payday loans is a sort of conspiracy between the top and the bottom against the middle. It benefits some and harms others, but its beneficiaries are less deserving than the more numerous population this policy harms. The policy of price deregulation rests implicitly on an extreme

principle of maximin that is insensitive to the suffering it imposes on a sizable population that is only slightly better off than the least advantaged group of risky debtors and whose lot can be improved by imposing a reasonable price cap.

For the sake of argument, the price cap I propose to defend in this paper is \$15 per \$100 for a 2-week payday loan, which translates into an annual percentage rate (APR) of 391 %. This is somewhat less than the average price in the United States for a payday loan in the legal market.³ Payday lending as a business is perfectly feasible at this price. About one-third of the states that permit payday lending cap fees at or below this level. I think an even lower cap could be justified, but in this paper I will defend not the policy of total prohibition but the position that a binding price cap in this particular market is fairer and has better consequences than the alternative of deregulated pricing.⁴ I am offering a defence, in other words, for what most states do if they do permit payday lending. There is a justification for imposing price ceilings in the most expensive credit markets that Labat and Block neglect and the justification is not medieval. It does not require us to think that lending at interest is evil, or that money is barren, or that debtors must be protected from themselves. The reason a usury cap is justified in subprime credit markets, I argue, is because these transactions produce negative externalities. The parties do not “assume all risks of their acts,” as Labat and Block stipulate, since the more solvent are compelled to cover the losses that occur when lenders gamble on the most marginal debtors. A moderate usury limit tilts appropriately toward the somewhat less risky borrowers who are more likely to pay back their debts. It tilts away from the riskiest borrowers, who are a burden to the more solvent in a struggling population.

The Case for Deregulated Pricing

As Jeremy Bentham pointed out in his famous *Defence*, the offense of usury can be defined in two different ways:

one is, the taking of a greater interest than the law allows of: this may be styled the *political* or *legal* definition. The other is the taking of a greater interest

³ According to a survey conducted by the Consumer Federation of America, the average price of a 2-week payday loan in the United States when measured as an annual percentage rate is 474 % (Mierzewski and Fox 2000, p. 7). The average would be higher if internet payday loans were included.

⁴ Prohibition is warranted if the product traps many consumers (Mayer 2010). Even when warranted, however, prohibition can be difficult to impose. My view is that if the product is going to be tolerated, then at the least a rate ceiling should be imposed at the level I am defending in this paper.

than it is usual for men to give and take: this may be styled the *moral* one: and this, where the law has not interfered, is plainly enough the only one (Bentham 1787, pp. 7–8).

Usurious lending therefore raises two questions, one moral and the other political. The moral question is whether it is unethical for an individual to lend to others at an unusually high rate when the law permits it. The political question is whether the community should prohibit individuals from extending credit at an unusually high rate. Answering the first question in the affirmative does not mean the second question should be answered in the affirmative, for not every unethical action should be made illegal. The community might accord individuals the right to do wrong, for instance, because the cost of detecting and adjudicating the wrong exceeds any benefit that might result from its punishment (Waldron 1981). Lying is an example. It is frequently wrong but is criminalized only in special cases. Usury might be tolerated, then, even if it is thought to be unethical. Hence, the really important question with regard to usury is the political one: whether charging an unusually high rate of interest for credit should be legal, even if it is somehow unethical.

There can be no dispute that payday lenders do charge an unusually high rate of interest when calculated as an APR, a requirement imposed on every creditor by the federal Truth in Lending Act.⁵ Nationally, the average annual rate charged by payday lenders exceeds 400 %. The rate is so high because the term of these single-payment loans is short. In a typical transaction, the borrower leaves in pawn with the lender a bank draft postdated to the next payday and written for the amount of the principal plus the interest charge (Stegman 2007). The underwriting process is quick and customers can typically exit the store with a cash advance in less than 20 min. On payday, borrowers must return to the store and redeem their check for cash. A lump sum is due unless state law permits customers to renew the loan for an additional fee. In the absence of a usury cap, the fee charged to borrow \$100 currently ranges from \$18.50 to \$30, depending on the state.⁶ Calculated as an APR for a 2-week loan, the cheapest deregulated loans cost 482 % and the most expensive ones 782 %. The usury cap I aim to defend in this

paper is half the price of the most expensive uncapped loans: \$15 for every \$100 borrowed, or 391 %. If payday lending is going to be permitted at all, I will argue, this threshold ought to be the maximum rate of interest any state government should permit.

Labat and Block, however, oppose usury caps in principle. They seek “to justify the practice of charging interest on loans, at *any* rate agreeable to both borrowers and lenders” (Labat and Block 2012, p. 383). The authors can see nothing ethically wrong in charging an unusually high rate of interest, whatever it might be, as long as the transaction is voluntary: “Surely, if two parties agree to a commercial interaction, it must be beneficial to *both*, or they would not agree to engage in it” (p. 385). They deny that this type of transaction can be economically exploitative or involve taking unfair advantage. Since the trade of cash now for more cash later is freely made and mutually beneficially, *ex ante*, it cannot be unfair. The lender has not harmed the borrower or violated any of her rights. Although they do not address the question, Labat and Block appear to reject the possibility of mutually beneficial exploitation, about which much has been written by moral philosophers over the last generation (Wertheimer 1996). Even thinkers who tilt in a libertarian direction have acknowledged that exploitation or wrongful gain can occur when a trade is voluntary, fully informed, and mutually advantageous (Feinberg 1988; Zwolinski 2007). Labat and Block, however, appear to subscribe to a minimalist theory of exploitation. If an exchange is voluntary, they maintain, it is fair. Hence, government has no excuse to interfere with this transaction to prevent unfairness.

To be sure, the wage-earners who contract for payday loans typically have lower than average incomes and they will certainly pay higher than average prices for this type of credit. In this market, like many others, the poor pay more (Caplovitz 1963). As Labat and Block (2012) note, “It is usually true that people with low income are charged a higher rate of interest than those with more wealth, but this is due to the differential rates of repayment. The poor are less likely to repay their loans than the rich” (p. 385). The lender therefore assumes more risk. A payday loan is secured only with a postdated check, which is often worthless when the lender tries to cash it in case of default. The debt is undersecured because the customers are typically asset-poor or want the convenience of borrowing without having to provide tangible collateral. Small, short-term loans of this sort are also invariably expensive to service, which inflates the lender’s cost still more.⁷ Labat

⁵ Because the loans are short term, the payday lending industry objects to the requirement that fees must be stated as an annual percentage rate. This is like requiring hotels to state their rates as if guests were going to stay a year, they say. The counterargument is that unless the price of credit factors in time, consumers will not be able to compare accurately the cost of different credit products (Peterson 2003).

⁶ The six states in 2012 that do not cap prices for payday loans are Delaware, Idaho, Nevada, South Dakota, Utah, and Wisconsin. Pricing information can be found at the web site for Advance America, the largest national chain: <http://www.advanceamerica.net/>.

⁷ If you have \$100,000 to lend, it is much cheaper to divide the principal between a few clients who make monthly payments than processing the paperwork and managing the accounts for hundreds of customers who borrow small sums for short terms. The latter business is much more labor-intensive.

and Block are right that “the poor pay high rates of interest, but more often default on their loans, which cost the lenders in revenues that go uncollected” (p. 385). These losses must be covered by the customers who do pay, but this is true in any credit business. Labat and Block do not think it is unfair for high-rate lenders to charge the low-income populations they serve whatever risk premium the market will bear, regardless of its distributional effects. The transactions they describe seem to produce no externalities or third-party effects.

Since usurious lending, on this analysis, does not seem to result in harm to others, the only remaining justification for prohibiting the transaction would appear to be harm to self, or paternalism. Credit-constrained consumers who are tempted to borrow at high rates, the argument goes, miscalculate and will set back their own interests by paying too much for credit. Government should therefore take away their freedom to contract for their own sake. Like other libertarian thinkers, Labat and Block (2012) appear to reject paternalistic arguments in principle, as an infringement of personal liberty (p. 387). A consequentialist, however, will not be deterred by this sort of objection because it cannot be ruled out that paternalistic restrictions may increase social well-being. Prohibiting risky behavior may produce good consequences for the individual and for society (Arneson 1989).

Labat and Block, however, deny that proscribing usury will benefit the populations most likely to borrow at high rates. They point out that criminalizing usury is likely to produce a black market for credit. The rates there will be higher still and the methods of debt collection less savory than in the legal market. Loan sharks will proliferate and cater to the demand that cannot be supplied when government imposes a usury cap. Far from benefiting credit-rationed borrowers, the paternalistic law actually makes them worse off (Labat and Block 2012, p. 386).

Labat and Block offer a fictional example to illustrate their argument. The going rate for prime loans is 5 % but a prospective borrower (A) has poor credit and no collateral. He does not qualify for a prime loan, but another creditor (B) would be willing to lend to him at 20 %. The government (G), however, sets the usury cap below this level, which drives the subprime borrower into the black market. The loan shark (LS) with whom he then enters into an agreement charges an APR of 500 % and employs violence in case of default. Labat and Block ask, “Did G really help A by driving him away from B and into the arms of LS? It is difficult to see that this would be the case. Very much to the contrary, it is clear that G *worsened* A’s position with this supposedly humane and generous ‘protection’.” Labat and Block go so far as to say that usury laws “attack the impoverished” and “single out the poor for disproportionate punishment” (p. 386). These laws cause harm; they do not prevent it.

The example is clearly fanciful. Only three states out of 50 (Arkansas, Pennsylvania, and Vermont) currently impose a usury cap below 20 % a year for small sums. To be realistic, B would have to offer A credit for a fee in excess of 391 %—the legal limit I want to defend—and LS would have to be extending credit at a rate exceeding 782 %—the highest rate likely to be charged for a 2-week payday loan in a deregulated market. Still, the objection to paternalistic usury laws is clear enough. Credit outside the legal market is said to become more expensive and collection methods harsher when government caps interest rates. Labat and Block predict that

with the repeal of usury laws, rates of interest will likely fall. They will do so since the high interest rate black markets will disappear. Government control ultimately leads to more risk for the moneylender. This only drives up the costs that borrowers must expend, which raises the interest rate for those who borrow (p. 386).

Usury statutes are said to produce the perverse and unintended consequence of forcing the poor to pay more for credit. Deregulation would benefit them and ease their plight.

Jeremy Bentham made the same sort of argument in defence of usury more than 200 years ago. But Labat and Block apply this libertarian logic to the domain of payday lending, which Bentham never contemplated when he set out to defend usury. In what follows I will show why this type of argument fails in the market for payday credit. Usury limits ought to be imposed in that market, but the justification I will offer is not paternalistic. The aim of the usury statute I defend is to prevent harm to others, not harm to self. But to see how payday credit causes that type of harm, one must understand how this market operates in practice.

Calculating the Just Price for Credit

The usury statute is an ancient institution. In most societies where such laws have operated, interest has been limited but not prohibited. The Code of Hammurabi, for example, capped the rate of interest for money loans at 20 % per annum while the Code of Justinian permitted only 12 % (Homer and Sylla 2011). But the historical record is so sketchy that it is difficult to ascertain how these traditional thresholds were set. There are sophisticated philosophical justifications for prohibiting interest entirely or for deregulating the price of credit, but not for pegging the legal rate somewhere in-between these two extremes. In more modern times, where usury statutes have been imposed, legislators have often argued about whether the legal rate

should be higher or lower. But they typically justify the thresholds they prefer in terms of expected consequences. Raise or lower the ceiling, they hypothesize, and trade will flourish or bankruptcies will decrease, and so forth. But the advocates specify no rule about where the limit should be set in any given market or how the just price for credit should be calculated. The implicit principle, it seems, is simply do whatever maximizes social well-being.

Only in more recent times has a better way been devised to establish the appropriate legal maximum for high-priced credit. Early in the twentieth century, progressive reformers in the United States fashioned a Uniform Small Loan Law, which permitted licensed lenders to charge higher rates for small sums than had been permissible under the traditional usury statutes. The model law capped the price of consumer installment credit at $3\frac{1}{2}$ % a month or 42 % a year. This was touted as the “scientific rate of interest” because it was based on the practical experience of responsible lenders who opened their books to the reformers and proved they could not service the demand for their credit product at a rate below this level (Anderson 2008; Mayer 2010). Further experimentation demonstrated that the price could be reduced to 36 % without starving the industry into extinction, and that became the customary just price for consumer credit in the United States. This rate still endures in states like New Hampshire and New Jersey, where payday lending is not permitted. The maximum permissible rate for small sums paid on the installment plan was supposed to be the minimum feasible price for-profit lenders could afford to charge. My claim is that if short-term, single-payment loans (what we call payday lending) are going to be permitted at all, their price should be capped at this ascertainable rate. The just price for payday credit is the minimum feasible price.

Based on the evidence available to us, the minimum feasible price for payday loans in the United States is roughly \$15 for every \$100 borrowed, or an annual rate of 391 % when the loan term is 2 weeks. As noted above, this is the mandated price in about one-third of the states where payday lending is both permitted and feasible. Experience demonstrates that payday lenders can do a good business when the price is capped at this level, at least if they are efficient. A recent study that examined the effect of loan fee limits on the industry reports that the volume of business did not fall when prices were capped at this level compared to the deregulated price, although the composition of the lender and borrower populations did change somewhat (Avery 2011). Smaller and less efficient operations were driven out of business and the risk pool seems to have been altered (in ways I will describe in the next section of the paper), but the overall market did not contract. The study also reported that fee caps much below this particular level did begin to reduce loan volume and kill off

the industry, which means that the \$15 rate is approximately the minimum rate that must be charged if the aim is not to reduce access to or prohibit payday lending. I maintain that it should operate as the just price in this market and that it is, at the least, a fairer price for more borrowers than the usurious free-market price defended by Labat and Block.

Just and Unjust Prices

It might be thought that the price differential between the regulated rate I am defending in this paper and the free-market rate for a payday loan is insignificant. In Minnesota, the capped rate for a \$100 loan is \$15, but cross the Mississippi River into Wisconsin and the standard rate at a payday loan store in this deregulated market is \$22. The difference is \$7. That is two lattes at Starbucks. Why make a fuss over \$7?

Note, however, that the typical sum advanced by payday lenders is roughly \$300 (Samolyk 2007). At the rates listed above, the price differential for the same principal is now \$21. Calculated in percentages, the higher rate is nearly 50 % more than the lower one. This gap swells still further if the borrower secures the cash advance over the internet. The price will be the same in the state with a usury cap because the law says rates must be calculated according to the borrower’s location, not the lender’s. But where no usury limit operates, the going rate for an internet payday loan will be even more than the already higher prices charged by the neighborhood stores.⁸ In Wisconsin, the internet payday lenders charge \$25 per \$100 borrowed. In Delaware, another free-market state, some national chains charge \$30 for internet cash advances. Compared to states where the rate is capped at \$15, the typical borrower in Delaware who wants a loan of \$300 delivered through the internet will pay \$45 more in fees, or twice the rate, for the same lump sum. That is a dozen lattes or, less frivolously, a 100 diapers.

Note, too, that the average payday loan customer nationwide borrows not just once but eight times during the course of a year (Bourke et al. 2012). The typical internet payday borrower who lives in Delaware will therefore spend \$360 more in fees over 12 months for the same debt contracted by a resident of a state where the fees are limited at the level I am defending. That might be two car payments for somebody on a budget or half a month’s rent. If the two debtors we are comparing borrow continuously

⁸ Many goods purchased through the internet are cheaper, but payday loans are not. Two facts explain this anomaly: the default rate for internet lending is very high and the consumers are charged a premium for the convenience of not having to present themselves in person at a loan store.

over the course of a year, as more than 25,000 residents of Florida did in 2010, the individual who lives in the state with the usury cap will save nearly \$1,200 in fees (Veritec Solutions 2010).

This is not a trivial difference, especially for the population that tends to borrow from payday lenders. Because they are wage-earners with a checking account, these consumers are not the poorest of the poor, but most do earn modest or below-average incomes. They often have children but are less likely to be married than the general population; many are single mothers. Most have little savings and blemished credit. Payday borrowers are much more likely than the average person to have bounced checks, paid bills late, or declared bankruptcy in the past (Lawrence and Elliehausen 2008). These are people, in other words, who are likely to have a high marginal rate of utility for cash. Small sums matter more to them. The importance of relatively small savings for this population should not therefore be underestimated. For people in their straitened circumstances, the difference between a fee of \$15 and \$22 or \$30 is significant.

At the same time, and paradoxically, it is well known that demand for these loans is relatively price inelastic (Avery 2011, pp. 4, 19). People who borrow on the security of a postdated check and who need money urgently are known to have “a limited taste for price shopping” (Mann and Hawkins 2007, p. 883). They frequently go to the store closest to where they live or work. The lenders, in turn, do not make it easy to bargain hunt because many will not disclose rates over the phone. What is more, every lender tends to charge the same rate in any given local market. If a price cap is in effect, all rates converge on the cap (De-Young and Phillips 2007). Where there is no cap, the prices still do not vary. In this market, as a rule, there is neither price competition nor price discrimination (Chessin 2005, pp. 408–409). Whether your credit is good or bad, or your income is high or low, or you borrow for 1 week or 2 weeks, the price you will pay in any given state is unlikely to vary.⁹ This does not mean the lenders deliberately collude. They must compete against each other for customers. But they are fortunate in vending a product for which demand is relatively inelastic. Mortgage shoppers, by contrast, tend to be very price sensitive and the rates they are charged vary according to risk. The opposite trends prevail in the market for the most expensive form of credit.¹⁰

⁹ Few payday borrowers have high incomes or good credit, but the point is that even the few who do will be charged the same price as the poorest risks. Prices do not vary based on risk.

¹⁰ “Competition does not appear to affect fees charged in the way one normally thinks that competition will affect loan market interest rates” (Flannery and Samolyk 2005, p. 10).

Advancing cash on the security of a postdated check to low-wage consumers with bad credit is a risky business. The probability that a new customer will default on the first loan is significant. One study that gained access to proprietary data reported that one in eight new customers at a particular chain failed to pay back any of the initial cash advance. Over the course of 12 months after the first loan half of the customers defaulted, though the typical one paid five fees before doing so (Skiba and Tobacman 2008, p. 6; Dobbie and Skiba 2012, p. 6). These trends are representative. A study of payday lending in Oklahoma revealed that more than one-third of new customers will default or fail to pay back a loan on time during the first year after they contract for this type of credit (King and Parrish 2011, p. 9). Of the fee revenue a typical store collects, as much as one-fifth must be set aside to cover bad debts (Huckstep 2007, pp. 229–230). That means a sizable fraction of the expensive fee check-borrowers pay on every cash advance is a risk premium the lenders pass on to them as a cost of doing business.

In every credit business, the customers who pay off their debts also cover the customers who do not. But default is much more common in the payday loan market than in prime-rate credit markets. That means the burden on those who repay is heavier. It is heaviest where the fees are not capped because lenders can take more risk and charge the expense to the paying customers. Textbook economics predicts that where a binding usury cap is imposed, lenders will be forced to select their customers more carefully and reject the riskiest prospects to whom they might otherwise have extended credit.¹¹ If they do not, the higher default costs they incur will eat up their profits. As a survey of the literature on the economics of rate caps explains, “If a credit market has restrictive usury limitations placed on it, credit gets rationed by denying loans to customers who are poorer risks” (Nathan 1980, p. 262). We should therefore expect lower default rates in states where fees are capped below the market-clearing level, and this is indeed what we do find in practice. A recent econometric analysis of proprietary lender data confirms the expectation: “Higher interest rates also result in increased likelihoods of default” (Li et al. 2011, p. 18). The authors of the study estimated that reducing the fee charged for a 2-week \$100 loan from \$23 to \$10 lowered the probability of default by 8 % (p. 23). In this case, the reduction in losses

¹¹ Alternatively, the creditors could reduce the amount of principal they lend to the riskiest clients (Gonzalez-Vega 1984). Hence less would be written off in case of default. That strategy would not produce total credit exclusion for the riskiest population. These consumers could still borrow but would not be extended as much credit at high rates. If lenders adopt that strategy, the objection to usury controls is even weaker than if the lenders ration the worst risks out of the market. I will therefore set aside this possibility in order to meet the tougher case. In my analysis I will assume that creditors reject more applications when a price cap is imposed.

was achieved without any credit exclusion because the lender imposed uniform minimum qualifications for approval in all of the jurisdictions where it did business. The drop in losses in the most restrictive jurisdictions occurred solely because the credit was cheaper by half and thus much less burdensome to debtors. This research demonstrates that where fees are deregulated and thus very high, some customers who do default would not default if the interest burden was lowered through government action.

However, it should be noted that where rates are capped by law the fee revenue lenders collect declines more quickly than default losses do. The loss in fee revenue, in other words, is only partially offset by the reduction in defaults. A profit-maximizing lender who is not permitted to raise fees therefore has an incentive to be more conservative in extending credit. As a classic study of risk in consumer lending explains, “State usury laws (that limit the amount that can be charged) reduce the lender’s expected cash inflow from borrowers and hence increase the benefit to the lenders from screening out high-risk borrowers” (Benston 1977, p. 594).

Though their underwriting process is expedited, payday lenders do have the means to estimate the relative risk of applicants. Many pay a fee to a subprime credit service, Teletrack, which scores the creditworthiness of new customers. One study concluded that Teletrack is eight times more reliable in predicting default for payday loan customers than a standard (FICO) credit score (Agarwal et al. 2009, p. 412). Another study showed that “for every additional \$50 of available credit, borrowers with above-median credit scores are 2.13 percentage points less likely to default than borrowers with lower credit scores are” (Dobbie and Skiba 2012, p. 13). Firms can reduce their default losses, then, by increasing the minimum score required to borrow. Alternatively, they can achieve the same result by reducing the dollar amount of credit they extend to their higher risks.

The evidence is clear that states with effective usury caps do record lower default rates for the payday loan product. Less debt is written off and covered by the relatively more solvent when fees are capped. Interestingly, lowering the maximum rate to the vicinity of \$15 (per \$100 borrowed) does not reduce the total quantity of lending in a state. Inefficient stores with fewer customers tend to fail, but the more efficient providers pick up the slack so that aggregate loan volume is unchanged. Hence, “fee ceilings can reduce borrower costs without much of an effect on the availability of the credit product” (Avery 2011, p. 16). When the cost falls, some consumers who would not borrow at the higher, unfettered rate will do so now. They substitute for the riskiest applicants who are rationed out of the market by fee caps in order to reduce the rate of default. The Federal Reserve study I have cited reports that “as

payday loan fee ceilings rise, black or female-headed household usage disproportionately rises” (Avery 2011, p. 25). These populations have the highest default rate. It is their relatively greater insolvency that is subsidized by the customer pool that pays back its payday debts.

The study concludes that “laws to lower fee limits up to some point would be beneficial to consumers, whose demand for these loans is price inelastic and who are using the loans to make ends meet” (Avery 2011, p. 27). When a usury statute is imposed in this market, a few who are the riskiest prospects may lose access to this product but the great majority who still qualify for the loans pay substantially less in fees.¹² Labat and Block completely neglect this side of the question. They side entirely with the riskiest borrowers (and the lenders who try to profit from them) but ignore the significant benefit that accrues to the majority of more solvent customers when rates are capped.

The distribution of costs and benefits that results when payday-advance fees are not capped is an example of cross-subsidy in a market systematically distorted by asymmetric information, as credit markets typically are. Adverse selection occurs in this kind of market. “Inefficiencies due to adverse selection arise when [lenders] cannot adequately distinguish safe borrowers from riskier borrowers. When that happens, all borrowers are charged the same interest rates, and safer borrowers end up effectively cross-subsidizing riskier borrowers” (Armendariz de Aghion and Morduch 2005, p. 51). Cross-subsidization has a technical meaning in economics: “a group cross-subsidizes all other consumers if it faces prices which exceed the costs to the group of going it alone, that is if it pays more than its stand alone costs” (Ralph 1992, pp. 3–4). This is the case for the more solvent payday borrowers who will be charged a \$22 or a \$30 fee in states without a usury cap but who could also be serviced profitably if the rate was \$15. They subsidize a population of riskier customers who are allowed to borrow when the rate is very high but who will be rejected when the rate is reduced to \$15. The riskiest population could not be served even at \$22 if the more solvent population dropped out of the market and did not subsidize its risk, but the opposite is not true. The better risks are taxed to cover the worse but the tax is not justified on the grounds that the product could not feasibly be offered to anyone at a lower rate. A lower rate is viable in this case but lenders earn more profit when the fee exceeds the minimum feasible level.

If the lower risk population could be served profitably at a fee of \$15, which experience demonstrates is true, we

¹² The study does not estimate how many borrowers are excluded when a rate cap is imposed, but the proportion must be small because the total quantity of borrowing is unchanged as rates fall to the minimum feasible price.

might wonder why some savvy entrepreneur in the market where a usury rate is not imposed does not swoop in and try to capture the safer risks by undercutting the competition. This lender could charge \$15 instead of \$22 or \$30 and still earn a profit because the default rate will fall. Would not the better customers flock to a lender who touted sizable rate cuts? This ought to happen in a highly competitive business. But certain features of the market for payday loans weaken price competition. Indeed, there is evidence of tacit price collusion. According to Bertics (2005), the deregulated market for fast cash functions “at an equilibrium that is harmful to consumers, where payday lenders are collecting economic rent” (p. 134). This occurs, to begin with, because there are barriers to entry by banks and credit unions, due to reputational risk, servicing costs, and incumbent advantage (pp. 143–144). As a result, competition is reduced. Furthermore, price comparison is made difficult for consumers. Rates are not disclosed over the phone. Borrowers must come into the store, fill out paper work, and then submit to employment verification before an APR is disclosed or they can be sure credit will be extended. Interaction with shoppers is designed in such a way as to render them heavily vested in their first option. But “when payday lenders increase the cost of gathering information, buyers cannot efficiently price shop” (p. 143). This market imperfection is intensified by lack of borrower sophistication and the urgent need for cash. In this market, convenience dominates over price. “Under this incentive structure the priority for lenders is to make themselves the first option potential borrowers will inspect.” The businesses therefore compete against each other with “flashy signs, promises of quick cash, location, and name recognition, rather than price reduction” (Peterson 2003, p. 895). They have an incentive to do so. This convergence of factors so distorts the market for payday credit that, “even for the customers focused on comparing alternative payday loan products, there is little reason to be sanguine about the robustness of competitive forces” (Mann and Hawkins 2007, p. 882). The pooling equilibrium that makes possible the cross-subsidy imposed on the more solvent borrowers is sustained by a defective competition.

In this kind of market, no lender has a financial incentive to charge less than the going price because revenue falls faster than the default rate. Hence, the profit rate will decline. In the market for payday loans, “higher fees increase revenues by more than they increase loan losses” (Flannery and Samolyk 2005, p. 16). The lenders do better by charging a higher price and loosening their selection criteria. According to one study, “Although the interest rate reduction leads to ... an overall decrease in the probability of default, the mean effect of this reduction on lender revenues remains negative” (Li et al. 2011, pp. 23–24). Only an unusually risk-averse or altruistic

lender would voluntarily cut prices in this type of market. The profit-maximizing strategy is to accept more risk, charge every customer a higher price, and compel the more solvent to cover the resulting losses. The solvent pay the cross-subsidizing tax because their need for cash is urgent.

This is a clear case of what is called mutually advantageous exploitation. The lender does not coerce the more solvent payday borrower to make a trade but nonetheless gains at her expense by taking unfair advantage of her inelastic demand for credit to get her to subsidize his riskiest prospects, who do not pay their stand-alone cost. The lender earns more profit, the least solvent pay less for credit than they otherwise would, but the more solvent are worse off than they would be if government capped the price of credit. The free market produces this result. It gives lenders an incentive to shift the risk and impose a burden on a population with whom we ought to align ourselves.

If relative solvency is the measure, the riskiest payday customers are the least advantaged group in this scenario. The lenders are the most advantaged group. But the middle group is by far the largest. It consists of all those to whom it would be profitable to lend at the fee of \$15 but who are charged some higher price in the deregulated market. This population is only slightly better off than the least advantaged group but its interests are sacrificed in the deregulated market in order to improve the lot of the numerically smaller population that would not be extended credit if a moderate usury cap was imposed. This example illustrates what is wrong with the maximin principle, which tells us to select the policy that raises the least advantaged group to the highest feasible level. The policy of deregulated pricing seems to rest implicitly on a maximin principle.¹³ It sets aside any gains, no matter how large, that would accrue to the slightly better off population, no matter its size. Because it accords absolute priority to those who are worst off, the principle tells us to forgo even huge gains to others in order to improve the lot of the least advantaged group just a tiny bit.¹⁴ A moderate usury cap in this market, by

¹³ The case for deregulated pricing need not be based on the maximin principle. It could be based on a right to free exchange with which government should not interfere even if the restrictions enhanced social well-being. But in making the case for deregulated pricing, the authors with whom I am concerned in this paper emphasize heavily the plight of the least advantaged group. They reject price ceilings *because* these ceilings allegedly harm the poor. The implication is that government should never act in such a way as to set back the interests of the least advantaged group. It is this sort of argument in defence of deregulated pricing I am challenging in this paper.

¹⁴ “In some cases benefiting the worst off may have the untoward consequence of burdening large numbers of people with significant losses. This is especially difficult to justify if those who must incur losses as a result of an egalitarian policy of distribution are only slightly better off than the worst off to begin with, or if benefiting the worst off does little to alleviate their condition of need” (Glannon 1995, p. 428).

contrast, increases aggregate welfare but fails to raise the least advantaged group as high as possible. It is the policy we would select if consequences decide the question and we do not discriminate in favor of the least solvent debtors. Usury statutes always favor the relatively strong over the relatively weak in the population that would like to borrow.¹⁵ But in the most expensive credit markets we ought to tilt toward this relatively stronger population because it is not much better off than the least advantaged group, it is much more numerous, and it is more creditworthy. If we tilt in the other direction and deregulate prices, we will put the few before the many, enrich the most advantaged group, subsidize risky behavior, and increase the problem of moral hazard.

The defence of price deregulation formulated by Labat and Block is oblivious to the trade-offs their favored policy requires. They imply that everyone who enters the market for payday credit—lenders and borrowers—loses when prices are capped. Only the regulators gain. But this is false. There are winners and losers when prices are capped or uncapped.¹⁶ Where usury is outlawed, marginal borrowers may lose access to legal credit. But a substantially larger population is freed by this policy from carrying the burden of risk these marginal debtors impose. A usury statute is justified not so much because losing the option to borrow is good for the riskiest debtors (though for some it could be) as because it is good for the struggling population that is a little more solvent. If lenders are allowed to charge whatever the market will bear, this worthier population pays the price. They will be taxed unfairly. A usury statute prevents lenders from levying that tax. It prevents them from exploiting the more solvent borrowers.

¹⁵ As Goudzwaard (1968) explains, usury laws “reallocate credit among the various risk classes.... Borrowers in the intermediate and low risk classes will have the same or more credit available at similar or lower prices, but at any price ceiling inevitably high-risk borrowers will face credit exclusion” (pp. 178–179). In the market for commercial (or productive) loans, usury limits have undesirable consequences. They ration credit toward established firms and away from new entrants, whose businesses are riskier and must be charged higher rates. The policy hampers competition and reduces economic growth (Benmelech and Moskowitz 2010; Temin and Voth 2008). In the market for consumer loans it is still true that “usury laws are intended to protect the low risk borrowers, which they, in fact, do” (Boyes 1982, p. 274). But that protection is warranted, I am arguing, in the most expensive subprime credit markets because the beneficiaries tend to have low incomes and are not much better off than the riskiest debtors, who will be rationed out of the market by the price ceiling.

¹⁶ “There is little doubt that usury laws and small loan laws effectively lower the finance rate to many borrowers.... But it also seems likely that the maximum rate provisions ... restrict the availability of credit to marginal risk loan applicants” (Goudzwaard 1968, p. 177).

The Specter of the Black Market

A moderate usury statute imposed in a market like the one for payday loans benefits the majority of consumers, who pay lower prices than they would if pricing was deregulated. A much smaller population is made worse off, however, because this policy compels lenders to deny them credit in order to reduce the default rate. The people who lose out are not deemed sufficiently creditworthy to borrow at an APR of 391 %. They suffer credit exclusion when the government imposes a rate cap on the product.

The phrase “credit exclusion,” however, does not describe precisely the fate that Labat and Block (2012) predict awaits those wage-earners who are rationed out of the market for payday loans. These consumers will not be denied access to credit, they anticipate, but instead will be displaced from one market that is legal to another that is not (p. 386). Credit substitution will occur, for the illegal credit of a loan shark will replace the legal credit of a licensed payday lender. The usury statute is said to drive these rationed consumers into the black market where, it is assumed, their lot will be substantially worsened. The credit they seek will now be much more expensive and the collection tactics employed against them much harsher than if the usury statute had not been imposed in the first place. As a result, these debtors will be much worse off than before. The gains experienced by the majority of payday loan customers when prices are capped will be paid for dearly by the smaller class of least advantaged agents.

If this credit displacement does occur, and if it does impose such heavy losses on this disadvantaged population, then regulating the price of credit might well reduce social well-being even when more people are helped by this policy than harmed. It is unacceptable to bestow modest gains on the many if this result can only be achieved by inflicting terrible miseries on the few. If it is true that imposing price controls in the market for payday loans spawns many vicious loan sharks that policy ought to be rejected.

This argument is conditional, however. Its validity depends on the facts of the matter. Labat and Block appeal to this familiar loan-shark objection to show why interest-rate caps are welfare-reducing, but they do not substantiate the empirical assumptions upon which this kind of objection implicitly rests. The force of the loan-shark objection depends on five such assumptions, each of which turns out to be either largely or wholly false. Two of the assumptions concern the customers who are displaced by the usury cap; the other three concern the loan sharks who will allegedly service this displaced population. The advocates of price deregulation in the market for payday loans imply that (1) customers who are rationed out of this particular market have no other credit options except the black market; (2) these customers will not forgo more credit if they cannot get

payday loans or will be worse off if they do forgo more credit; (3) unlicensed loan sharks only exist where the price of credit is capped; (4) unlicensed loan sharks typically charge much more than licensed payday lenders in the freest markets; and (5) unlicensed loan sharks typically employ much harsher methods to collect their debts than licensed payday lenders. If these unstated assumptions were factually correct, the case against imposing fee limits in the most expensive credit markets would be strong. But the truth is that these assumptions are mostly false. The borrowers have more legal options available to them than the advocates of deregulation allow and the loan sharks whom the advocates conjure are mostly a media fantasy. In the market for small sums today, the licensed lenders are not very different from the unlicensed ones. Hence, the customers who patronize the latter will not be much (or at all) worse off than they would be if the market remained free. They do not suffer the heavy losses upon which the case for deregulated pricing crucially depends. That is why this case fails. The loan-shark objection is mostly myth (Mayer 2012). It cannot salvage the argument for *laissez-faire* in today's market for payday loans.

Let us consider each of these five assumptions in turn. The first thesis is that consumers who are excluded from the market for payday loans by a usury cap have no other credit options except the black market. It implies that credit substitution between the legal and illegal markets is perfect: all those who cannot borrow in the legal market will resort to loan sharks. On this assumption, the size of the population made worse off by the usury statute will be substantial.

But the assumption is surely false (Littwin 2009). Consumers who cannot be serviced by the payday lenders when prices are capped still have other legal credit options. Personal possessions or a car title can be pawned. Family, friends, employers, or charitable organizations can be approached for a cash advance. One study reports that a surprisingly large fraction of payday borrowers have unused credit on their charge cards or untapped bank deposits they were saving for the rainy day that has now arrived (Agarwal et al. 2009, p. 413). Denied the convenient option of borrowing against the security of a postdated check, other consumers might be forced to extend their search and fill out more paperwork to access forms of credit, like the installment loan or credit-union products, that cost less than a payday advance.¹⁷ For the applicants who qualify, the usury statute merely forced them to trade convenience for lower rates. This is a minimal sort of paternalism that could be justified by the hyperbolic discounting that some research shows tends to afflict the population that accesses payday credit (Skiba and Tobacman 2008). The larger point, though,

is that a moderate usury cap in practice produces less real credit exclusion than the advocates of price deregulation claim. Not everyone who is rationed out of the most expensive legal market for credit will actually lose access to legal credit. Some, at least, will just be shifted into a different subprime market. Hence, the size of the least advantaged group, already small, that can be expected to resort to the black market when prices are capped is smaller still. An assumption of perfect credit substitution between the black and white markets is unrealistic.

The second assumption is also unrealistic. It maintains that rationed borrowers will not forgo additional credit if they are rejected by the payday lenders or, alternatively, that these consumers will be worse off if they do not borrow more. Like the previous assumption, this one implies that credit substitution between the legal and illegal markets is perfect or, if it is not perfect, that any attrition that results when the riskiest borrowers are denied credit is detrimental for the consumers who stop borrowing. The assumption sustains the impression the advocates of deregulation want to create that the size of the subprime population whose lot is worsened by usury caps is large.

But there is good reason to expect that some who are rationed out of the market for payday loans will choose to tighten their belts and reduce consumption rather than turn to the black market for additional credit. No doubt this reduction in consumption will be painful if there is no slack in the household budget, but it is also true that more consumption does not always enhance well-being. Surveys of consumers who lost access to expensive credit due to more stringent regulation report that a surprisingly large fraction expresses relief and claims its lot was actually improved (Benston 1975, p. 41; Center for Community Capital 2007). They illustrate the conclusion reached by some sophisticated economic studies that, in certain cases, “financial innovation reduces welfare by providing ‘too much’ liquidity” (Laibson 1997, p. 446). The assumption that well-being invariably rises with the level of debt is surely false. For some fraction of the least advantaged group that experiences genuine credit exclusion when rates are capped, the inability to borrow any more will be beneficial and perhaps even welcomed (in retrospect if not in prospect). This ought to be the case for the sizable number of payday loan customers who appear to become trapped by their debts. The loans are justified by the industry as short-term emergency credit, but even in states with stringent regulations one in four customers borrows more than a dozen times a year.¹⁸ The problem is worse where the industry is lightly regulated. For the borrowers

¹⁷ To be sure, applicants with exceptionally bad credit are likely to be rejected for the cheaper credit products. But even people with poor credit can pawn personal possessions.

¹⁸ A recent study of payday lending in Oklahoma reported that borrowers were “indebted an average of 212 days in the first year they borrow,” or more than half the year (King and Parrish 2011, p. 5).

who are trapped, the APR is an accurate description of the product's cost. It is difficult to see how prolonged indebtedness at triple-digit interest rates for a low-income population can be welfare-enhancing. For this group, credit exclusion might be advantageous. If so, the size of the population actually made worse off by usury limits shrinks yet again.

The other three assumptions concern the black market into which the rationed borrowers are said to be driven. They imply that credit substitution seriously worsens the lot of the least advantaged group. Their well-being declines sharply when these wage-earners are displaced into the black market by the interest-rate ceiling. The severity of the loss they allegedly suffer more than makes up for the limited numbers who suffer this loss. Without these assumptions, the case for deregulated pricing looks weak. It is more difficult to persuade people to sacrifice significant gains for a much larger population of consumers who are not very well off if the expected losses a tiny group will suffer are negligible.

Labat and Block (2012) claim that if the price of credit is deregulated, black markets will disappear (p. 386). Their favored policy supposedly kills off loan sharks. That is the third assumption. But it is false. Even a free market in credit can and does spawn loan sharks. Both theory and empirical evidence confirm the point. Since imperfections like asymmetrical information are inherent in the market for credit, economic theory predicts that rationing and credit exclusion will still occur when prices are uncapped. The market does not clear and demand goes unmet due to adverse selection. The riskiest applicants will be denied credit by licensed lenders so as not to inflate the market rate of interest and chase away the safer prospects (Stiglitz and Weiss 1981). Unable to access credit in the legal market at any price, some fraction of the riskiest consumers can be expected to seek out credit from unlicensed lenders instead. The substitution will not be perfect, but it will occur in some degree. Experience confirms the theory. Labat and Block cite examples of criminal loan-sharking in Great Britain in recent years but neglect to mention that the usury limit was repealed in that country long ago (Taylor 2002, pp. 58–65; Ellison et al. 2006). Loan sharks do thrive even where interest rates have been deregulated because no legal lender can afford to service the riskiest populations. The truth is that some people are so unreliable they can never borrow unless the lender threatens bodily harm in case of default. That means a black market for credit is likely to emerge whether rates are capped or not.¹⁹

Theory predicts that the size of the black market should swell when the usury ceiling is low, but the real world

often defies these theoretical expectations. If the theory is true, there ought to be a lot of mob loan-sharking in states like Vermont, where the usury cap is stringent. But this is not the case. Court records indicate that no indictments have ever been filed in Vermont for engaging in an extortionate credit transaction, which is the technical term for loan-sharking under federal law (Mayer 2012). British newspapers report many harrowing stories of people victimized by loan sharks, but the press in Vermont has not. These facts demonstrate that the third assumption upon which the case for deregulated pricing rests is false. A black market in credit does not necessarily disappear once rates are uncapped and capping rates does not automatically spawn mob loan-sharking.

It is natural to assume that illegal credit should be more expensive than legal credit since the lender assumes more risk and is prevented by the law from operating efficiently. This is the fourth assumption: loan sharks charge much more than licensed payday lenders. Hence, black-market customers ought to be worse off financially than if they could borrow legally. But empirical accounts of mob loan-sharking from the days when it catered to working people challenge this assumption (Haller and Alviti 1977; Mayer 2010). Measured by the APR, the typical mob loan a half-century ago was no more expensive than the cash advances vended by today's payday lenders in the deregulated states. Many were less expensive. One Chicago "juice" lender who worked the factories back in the 1960s reported that he charged 10 % a week for small loans, or 520 % a year (Anonymous 1965). But in Wisconsin today, the going rate for 2-week payday loans from the storefront vendors is 574 %. The rate internet lenders charge is even higher. These facts conflict with our theoretical expectations about credit pricing because the real world is more complicated than the theory recognizes.

The fifth assumption also deviates from what we know about mob loan-sharking. It predicts that loan-shark customers will be worse off because the lenders employ violence to collect their debts. Generalizations like this, however, mistake the exception for the rule. The resort to violence by unlicensed lenders has been less frequent than media depictions suggest (Mayer 2010, pp. 106–107). One authoritative study reported that "most loan-shark transactions are amicably conducted with both parties being satisfied" (Staff 1969, p. 97). Debtors were motivated to repay their loans not only to avoid injury but also to sustain a vital line of credit. As one old-time mob payday lender explained, "When business is good in a smoothly-run operation, muscle is seldom needed for collections" (Anonymous 1965, p. 41). One of the few empirical studies of a mob loan-shark operation confirmed this observation. Based on FBI case files, the study reported that interviews with more than a 100 customers of the loan business turned

¹⁹ Mosciandaro (2001) demonstrates theoretically that "usury markets can be reduced but not eliminated" and that this would be the case even "where there is competition and perfect information within the credit markets" (pp. 193–194).

up only one debtor who had been threatened. None were beaten (Anderson 1979, p. 66). To be sure, clients who fell behind on their payments could expect repeated phone calls and some harassment, but the same is true today for wage-earners who borrow on the security of a postdated check.

Criminal gangs exited the market for payday loans decades ago (Mayer 2010, pp. 108–111). Mob-connected loan-sharking now services a different population and does not deal in small sums. The real black-market substitute for legal payday credit today is not to be found in some back alley but on the internet, where unlicensed lending abounds (Fox and Petrini 2004). A wage-earner short of cash today and rationed out of the legal market is unlikely to search for a break-your-leg loan shark but will go online, where countless shadowy lenders promise cash in a hurry. Their prices are very high, but often no more than the prices charged in the deregulated markets. These lenders will harass defaulters by phone and sometimes tell them falsely that failure to pay will result in arrest, but the cyber loan sharks are in no position to beat their customers because they never meet them face to face. Technological change has transformed the nature of the black market for credit. Today's payday loan sharks are nonviolent and rarely more expensive than the licensed firms doing business in the deregulated markets (Mayer 2010, pp. 217–219). Hence, it is hard to see how any wage-earners with exceptionally bad credit who lose access to expensive debt where fees are capped at the rate I am defending are made significantly worse off than they would be when prices are allowed to rise for everyone in jurisdictions where no usury statute is in effect. The sharp drop in well-being upon which the case for deregulated pricing depends simply does not occur. The distance between the legal and the illegal markets for payday credit is slight in the twenty-first century.

If that is so, the calculus of gains and losses tilts rather dramatically away from deregulated pricing and toward the prohibition of usury. A small number of rationed borrowers may lose out when prices are capped at the minimum feasible rate, but those losses must be weighed against the gains experienced by the majority of consumers who pay substantially lower fees and have a reduced likelihood of default in states where a usury ceiling is imposed. Only a principle as uncompromising as maximizing the minimum will tell us to tilt in favor of the least advantaged group (those who experience credit exclusion) and away from the much larger population that is only slightly better off and that would benefit significantly from the price ceiling.²⁰

²⁰ “If the comparatively better off are not all that well off in absolute terms, and if the worst off are only slightly comparatively worse off than their counterparts, and their lot improves only marginally from the distribution in question, then it may be morally correct to say that benefits to the better off outweigh benefits to the worst off” (Glannon 1995, p. 449).

Surprisingly, the libertarian argument of Labat and Block appears to rest tacitly on just such a principle. It requires us to sacrifice the interests of the many to the interests of the few, but the argument does not disclose or defend this trade-off. The authors claim that usury ceilings always have perverse consequences, but they do not acknowledge the still more perverse consequences their favored policy entails in the market for payday loans. They say all borrowers will be better off when prices are deregulated, but that is not so. No regulatory policy in this market will make everyone better off. We must choose in which direction to tilt.

The Harm of Usury

Binding interest-rate ceilings interfere with free exchange. Such restrictions should be imposed cautiously. Free exchange ought to be our default rule. That means the advocates of restriction must shoulder the burden of proof. They have to explain why the default rule should be overridden in some particular case.

Paternalism is one possible justification. It says that free exchange should be curbed for the benefit of one or both parties. However, there is generally much opposition to such arguments. The opponents doubt that policymakers can know an agent's interest better than she does herself. Nonetheless, paternalistic policies can be welfare-enhancing. If agents suffer from cognitive biases but policymakers do not, restraint of trade could be beneficial. There is some evidence that payday loan customers are indeed plagued by such biases (Francis 2010). But it is also possible that more effective information disclosure might be able to correct such biases, obviating the need for more drastic interventions like the imposition of a usury statute (Bertrand and Morse 2011).

A more powerful justification for blocking free exchange is proof the trade produces negative externalities. As Coco and de Meza (2009) explain, the best answer “to Bentham's question of why prevent mutually agreeable trades” is that “there are effects on those not party to the transactions” (p. 1702). The latter bear costs but do not reap benefits from the exchange, which is not fair. Justifications for imposing usury limits have identified two classes of agents that suffer negative externalities when lenders are allowed to charge whatever the market will bear. One class is the public at large and taxpayers in particular. As Posner (1995) points out, “The provision of welfare in a free market produces perverse incentives to take credit risks, which both drive up the cost of the welfare system and undermine its goal of poverty reduction” (p. 285). This is the problem of moral hazard, which a free market in credit engenders. Where a minimum level of consumption is guaranteed, marginal debtors have an incentive to take excessive risks because some of their losses

will be covered by taxpayers. Hence, “restrictive contract doctrines are appropriate means for deterring this socially costly behavior” (Posner 1995, p. 285).²¹ If interest rates are not capped, the argument goes, taxes will likely increase to make up for the losses that result from excessive risk-taking.

If valid, this type of argument would probably justify a lower usury cap than the one defended in this paper. If high-interest credit does increase aggregate impoverishment, then payday lending (and other expensive credit products) should be prohibited.²² The welfare effects of payday lending, however, have not been established. Different studies point in opposite directions. It is extremely difficult to isolate the effect of payday lending in macro-economic analysis.²³ While it is plausible to think that usury caps “reduce the total amount of income supplement payments and hence reduce the tax burden on constituencies” (Avio 1973, p. 67), it could be the case that expensive credit actually smoothes consumption and thus reduces the need for welfare expenditure. If so, free exchange does not have third-party effects and usury limits are unwarranted.

But the other version of the argument from negative externalities is more certain. It is the one developed in this paper. Unless rates are capped, I have argued, the more solvent borrowers in the market for payday loans will be taxed to cover the greater losses that result when the creditors lend to the riskiest debtors. The more solvent borrowers subsidize this risk, which inflates their borrowing costs and also increases their own likelihood of default. That is neither fair nor desirable. A fee cap imposed at the minimum feasible level in this market ends this cross-subsidy and would almost certainly enhance aggregate well-being. If a few lose access to the product, many more benefit from the reduction in price.²⁴

Imposing a usury limit in the market for payday loans at the level I have specified is one way to prevent lenders from exploiting market imperfections to collect excess profits. Alternative strategies are available. Competition could be enhanced by facilitating entry into the market of lower cost lenders, such as the depository institutions, or by reducing the existing barriers to rate shopping. In theory,

either method is preferable to a price-control law. But the difficulty is putting theory into practice. The biggest advantage of a usury statute is that it is the quickest and least complicated way to put an end to rent-seeking behavior in this market. As Bertics (2005) observes, “usury regulation could be used to extinguish the economic rent that is arguably present in the current payday loan market, making loan terms more favorable to consumers.” However, “the effectiveness of usury limits for extinguishing rent is ... dependent on the ability of the regulator to predict the non-rent interest rate” (p. 147).²⁵ Fortunately, there is a sizable body of practical experience indicating that what I have called the minimum feasible price for a payday loan approximates the non-rent interest rate. The quickest way for legislators to end the abuse is to implement the strategy that is already working in other jurisdictions rather than devise a theoretically superior scheme that is both more complicated and untested.

When it is justified, a usury statute operates like a system of triage. The reduction in price it effects bestows a benefit on those members of a struggling population who are least likely to default. The usury cap frees these borrowers from the burden of carrying the most insolvent debtors. As a result, the debts of the majority become a little more manageable. But the lenders in a deregulated market have no financial incentive to produce this effect. They gain by pricing the credit in such a way that the more solvent subsidize the less. That is why the government must block the most egregiously usurious exchanges. In this way, the society cuts its losses, creates a modest incentive to avoid insolvency, and prevents the most insolvent debtors from taking risks for which other people who are only slightly better off are made liable.

References

- Agarwal, S., Skiba, P., & Tobacman, J. (2009). Payday loans and credit cards: New liquidity and credit scoring puzzles? *American Economic Review*, 99, 412–417.
- Anderson, A. (1979). *The business of organized crime*. Stanford: Hoover Institution Press.
- Anderson, E. (2008). Experts, ideas, and policy change: The Russell sage foundation and small loan reform, 1909–1941. *Theory & Society*, 37, 271–310.
- Anonymous. (1965). Confessions of a 6-for-5 “Juice Man”. *Burroughs Clearing House*, 49, 40–41.
- Armendariz de Aghion, B., & Morduch, J. (2005). *The economics of microfinance*. Cambridge, MA: MIT Press.

²¹ Other economists have developed sophisticated arguments that justify usury laws as protection for taxpayers or the public (Avio 1973; Glaeser and Scheinkman 1998; Espinosa-Vega and Smith 2001).

²² There is evidence that payday lending does increase financial distress (Melzer 2011). But other studies find the opposite result (Morse 2011).

²³ The empirical literature on the welfare effects of payday lending is still small, inconsistent, and not entirely reliable (Caskey 2010).

²⁴ Coco and de Meza (2009) offer an economic rationale for usury laws analogous to the one developed in this paper. They show that “if moral hazard leads to credit rationing, a just-binding usury law creates a deadweight gain” (p. 1691). Hence, “efficiency arguments may reinforce the case for regulating interest rates” (p. 1702).

²⁵ “When interest rates are above the efficient market rate, interest rate caps that are below what is currently being charged but at or above the efficient rate will not prohibit loans to that segment of the market entirely, but will only decrease the price of these loans” (Bertics 2005, p. 147).

- Arneson, R. (1989). Paternalism utility, and fairness. *Revue Internationale de Philosophie*, 43, 409–437.
- Avery, C. (2011). *Payday loans versus pawnshops: The effects of loan fee limits on household use*. Working paper, Board of Governors of the Federal Reserve.
- Avio, K. (1973). An economic rationale for statutory interest rate ceilings. *Quarterly Review of Economics and Business*, 13, 61–72.
- Baker, D., & Breitenstein, M. (2010). History repeats itself: Why interest rate caps pave the way for the return of the loan sharks. *Banking Law Journal*, 127, 581–603.
- Benmelech, E., & Moskowitz, T. (2010). The political economy of financial regulation: Evidence from U.S. state usury laws in the 19th century. *Journal of Finance*, 65, 1029–1073.
- Benston, G. (1975). An analysis of Maine's "36 month limitation" on finance company small loans, in: National commission on consumer finance. *Technical Studies*, 2, 1–63.
- Benston, G. (1977). Risk on consumer finance company personal loans. *Journal of Finance*, 32, 593–607.
- Bentham, J. (1787). *Defence of usury; shewing the impolicy of the present legal restraints on the terms of pecuniary bargains*. London: T. Payne and Son.
- Bertics, M. (2005). Fixing payday lending: The potential of greater bank involvement. *North Carolina Banking Institute*, 9, 133–158.
- Bertrand, M., & Morse, A. (2011). Information disclosure, cognitive biases, and payday borrowing. *Journal of Finance*, 66, 1865–1893.
- Bourke, N., Horowitz, A., & Roche, T. (2012). *Payday lending in America: Who borrows, where they borrow, and why*. Report, Pew Safe Small-Dollar Loans Research Project.
- Boyes, W. (1982). In defense of the downtrodden: Usury laws? *Public Choice*, 39, 269–276.
- Caplovitz, D. (1963). *The poor pay more: Consumer practices of low-income families*. New York: Free Press.
- Caskey, J. (2010). *Payday lending: New research and the big question*. Working paper, Federal Reserve Bank of Philadelphia.
- Center for Community Capital. (2007). *North Carolina Consumers after payday lending: Attitudes and experiences with credit options*. Report prepared for the North Carolina Commissioner of Banks.
- Chessin, P. (2005). Borrowing from Peter to pay Paul: A statistical analysis of Colorado's deferred deposit loan act. *Denver University Law Review*, 83, 387–423.
- Coco, G., & de Meza, D. (2009). In defense of usury laws. *Journal of Money, Credit and Banking*, 41, 1691–1703.
- DeYoung, R., & Phillips, R. (2007). Strategic pricing of payday loans: Evidence from Colorado, 2000–2005. *Federal Reserve Bank of Chicago: Proceedings*, pp. 260–279.
- Dobbie, W., & Skiba, P. (2012). *Information asymmetries in consumer credit markets: Evidence from payday lending*. Working paper, National Bureau of Economic Research.
- Ellison, A., Collard, S., & Foster, R. (2006). *Illegal lending in the UK*. Report, Personal Finance Research Centre.
- Espinosa-Vega, M., & Smith, B. (2001). *Socially excessive bankruptcy costs and the benefits of interest ceilings on loans*. Working paper, Federal Reserve Bank of Atlanta.
- Feinberg, J. (1988). *Harmless wrongdoing*. New York: Oxford University Press.
- Flannery, M., & Samolyk, K. (2005). *Payday lending: Do the costs justify the price?* Working paper, FDIC Center for Financial Research.
- Fox, J., & Petrini, A. (2004). *Internet payday lending*. Report, Consumer Federation of America.
- Francis, K. (2010). Rollover, rollover: A behavioral law and economics analysis of the payday-loan industry. *Texas Law Review*, 88, 611–638.
- Glaeser, E., & Scheinkman, J. (1998). Neither a borrower nor a lender be: An economic analysis of interest restrictions and usury laws. *Journal of Law and Economics*, 41, 1–36.
- Glannon, W. (1995). Equality, priority, and numbers. *Social Theory and Practice*, 21, 427–455.
- Gonzalez-Vega, C. (1984). Credit-rationing behavior of agricultural lenders: The iron law of interest-rate restrictions. In D. Adams, et al. (Eds.), *Undermining rural development with cheap credit* (pp. 78–95). Boulder: Westview Press.
- Goudzwaard, M. (1968). Price ceilings and credit rationing. *Journal of Finance*, 23, 177–185.
- Haller, M., & Alvit, J. (1977). Loansharking in American cities: Historical analysis of a marginal enterprise. *American Journal of Legal History*, 21, 125–156.
- Homer, S., & Sylla, R. (2011). *A history of interest rates*. Hoboken: Wiley.
- Huckstep, A. (2007). Payday lending: Do outrageous prices necessarily mean outrageous profits? *Fordham Journal of Corporate and Financial Law*, 12, 203–232.
- King, U., & Parrish, L. (2011). *Payday loans, Inc.: Short on credit, long on debt*. Report, Center for Responsible Lending.
- Labat, A., & Block, W. (2012). Money does not grow on trees: An argument for usury. *Journal of Business Ethics*, 106, 383–387.
- Laibson, D. (1997). Golden eggs and hyperbolic discounting. *Quarterly Journal of Economics*, 112, 443–477.
- Lawrence, E., & Elliehausen, G. (2008). A comparative analysis of payday loan customers. *Contemporary Economic Policy*, 26, 299–316.
- Li, M., Mumford, K., & Tobias, J. (2011). A Bayesian analysis of payday loans and their regulation. Working paper, Purdue University.
- Littwin, A. (2009). Testing the substitution hypothesis: Would credit card regulations force low-income borrowers into less desirable lending alternatives? *University of Illinois Law Review*, 403–455.
- Mangu-Ward, K. (2009). Payday of reckoning. *Reason*, 41, 40–47.
- Mann, R., & Hawkins, J. (2007). Just until payday. *UCLA Law Review*, 54, 855–912.
- Mayer, R. (2010). *Quick cash: The story of the loan shark*. DeKalb: Northern Illinois University Press.
- Mayer, R. (2012). Loan sharks, interest rate caps, and deregulation. *Washington and Lee Law Review*, 69, 807–848.
- Melzer, B. (2011). The real costs of credit access: Evidence from the payday lending market. *Quarterly Journal of Economics*, 126, 517–555.
- Mierzwinski, E., & Fox, J. (2000). *Show me the money! A survey of payday lenders and review of payday lender lobbying in state legislatures*. Report, U.S. Public Interest Research Group.
- Morse, A. (2011). Payday lenders: Heroes or villains? *Journal of Financial Economics*, 102, 28–44.
- Mosciandaro, D. (2001). In offense of usury laws: Microfoundations of illegal credit contracts. *European Journal of Law and Economics*, 12, 193–215.
- Nathan, H. (1980). Economic analysis of usury laws. *Journal of Bank Research*, 10, 200–211.
- Peterson, C. (2003). Truth, understanding, and high-cost consumer credit: The historical context of the truth in lending act. *Florida Law Review*, 55, 807–903.
- Posner, E. (1995). Contract law in the welfare state: A defense of the unconscionability doctrine, usury laws, and related limitations on the freedom to contract. *Journal of Legal Studies*, 24, 283–319.
- Ralph, E. (1992). *Cross-subsidy: A Novice's guide to the arcane*. Working paper, Duke University.
- Samolyk, K. (2007). Payday lending: Evolution, issues, and evidence. In S. Agarwal & B. Ambrose (Eds.), *Household credit usage: Personal debt and mortgages* (pp. 175–200). New York: Palgrave Macmillan.

- Skiba, P., & Tobacman, J. (2008). *Payday loans, uncertainty, and discounting: Explaining patterns of borrowing, repayment, and default*. Working paper, Vanderbilt Law and Economics Research Paper Series.
- Staff, (1969). Loan-sharking: The untouched domain of organized crime. *Columbia Journal of Law & Social Problems*, 5, 93–110.
- Stegman, M. (2007). Payday lending. *Journal of Economic Perspectives*, 21, 169–190.
- Stiglitz, J., & Weiss, A. (1981). Credit rationing in markets with imperfect information. *American Economic Review*, 71, 393–410.
- Taylor, A. (2002). *Working class credit and community since 1918*. New York: Palgrave Macmillan.
- Temin, P., & Voth, H. (2008). Interest rate restrictions in a natural experiment: Loan allocation and the change in the usury laws in 1714. *Economic Journal*, 118, 743–758.
- Veritec Solutions. (2010). *Florida trends in deferred presentment*. Report, Veritec Solutions.
- Waldron, J. (1981). A right to do wrong. *Ethics*, 92, 21–39.
- Wertheimer, A. (1996). *Exploitation*. Princeton: Princeton University Press.
- Zwolinski, M. (2007). Sweatshops, choice, and exploitation. *Business Ethics Quarterly*, 17, 689–727.