Christmas Borrowing and Indiana's Payday-Loan Law

For release Dec. 6 and thereafter
638 words

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The Christmas shopping season is a proper time, like it or not, to address the issue of chronic borrowing, especially in the context of Indiana’s growing payday-loan industry.

A criticism of 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.

Although this is a valid concern, both theory and evidence tell us to be skeptical.

First, the allegation that payday lending causes chronic or habitual borrowing may ignore the old adage that "correlation does not equal causation." 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, research indicates that 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 a visible fist of government in restraining excessive payday-loan rollovers.

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 draw the same shrill objections as 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.

So if there is concern this Christmas shopping season about the high finance charges on payday loans or the chronic borrowing that may result, the best method of bringing them down and dealing with both concerns is to repeal those Indiana regulations on payday lending that restrict competition and market entry.

Policymakers, rather than preventing or discouraging the proliferation of payday loan outlets, should 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 while making credit available even to marginal borrowers.

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