Evaluating the Welfare Impacts of the Payday Loan Industry in the United States

Payday loans—small short-term loans with high interest rates that become due at the time of the borrower's next paycheck—are a common form of lending to people with low incomes in the United States. Do borrowers taking out these loans make rational decisions, or do they borrow more than they expect or would like to in the long run? Researchers are working with IPA and a large payday lender to conduct an evaluation to better understand consumers’ decision-making with regard to payday loans.

Policy Issue
Payday loans—short-term loans with high interest due at the time of the borrower’s next paycheck—are a common form of lending to people with low incomes in the United States. These loans are usually for USD$500 or less and often have an annual interest rate of around 400 percent, more than ten times higher than the norm for US lending. While most financial loans require a certain credit score and/or collateral, payday loans tend not to; generally, borrowers need only present a bank account and proof of income. Proponents of payday lending argue that these loans provide credit to people who otherwise would not be able to access it in emergencies. Critics argue that the loans prey on people who are economically vulnerable, forcing them into expensive debt traps as they take on new loans to pay off older ones.

A question relevant to this debate is whether consumers are acting in their own best interest when they take out payday loans. Present focus, a behavioral bias which can lead people to borrow more to finance present consumption than they would like to in the long run, may push consumers to take out payday loans when doing so is not in their interest. Borrowers may be partially or fully aware of their own present focus, or they may not. Little rigorous evidence exists about behavioral biases in this decision-making context.

Evaluation Context
Payday loans are available in 32 US states and banned in 18. In 2016, Americans took out $35 billion in these loans and paid $6 billion in interest and fees. Nationally, over 80 percent of payday loans are either renewed or rolled over with another payday loan within two weeks. This evaluation is taking place in the state of Indiana, where the regulatory environment for payday loans is typical of other US states. Researchers partnered with a large national payday lender for this
study which took place in Indiana. In 2017, the average customer from this lender took out six loans per year. The average income of borrowers from the lender was approximately $28,870.

In 2017, the Consumer Financial Protection Bureau announced new regulations for payday lenders. The rules would require lenders to ensure that customers seeking a loan had the ability to repay it before being offered one and prevent lenders from making more than two unsuccessful attempts to debit a borrower's bank account. However, as of late 2019, the bureau has canceled the former rule and delayed implementation of the latter.

Details of the Intervention
Researchers are working with Innovations for Poverty Action (IPA) and a large payday lender to better understand consumers’ decision-making about payday loans. The research team implemented a survey evaluation to measure payday borrowers’ present focus (and self-awareness about potential present focus) and considered the implications of three commonly proposed payday lending regulations on consumer welfare.

Immediately after taking out a payday loan, borrowers participating in the study took a survey questionnaire, during which they were offered a theoretical choice between two rewards they would receive twelve weeks later. In one, the “Incentive” reward, they would receive a cash payment if they did not take out any more loans for eight weeks. In the other, they would receive a “Money For Sure” reward, a cash payment regardless of their future behavior. Borrowers were asked to repeatedly choose between the Incentive option and different amounts of Money For Sure (from what researchers call a “multiple price list”). From here, participants were randomly divided into four groups:

- **Incentive**: This group was offered the Incentive reward.
- **Money for Sure**: This group was offered the reward they chose on a randomly selected question of the multiple price list.
- **Flip a Coin**: This group was offered a 50 percent chance of winning $100 or nothing.
- **Comparison**: This group was not offered a reward.

The survey also asked consumers how likely they were to borrow again, and to estimate how long it would take them to pay off the loans they had taken out and how much the resulting interest and fees would cost.

Researchers are comparing the data from this survey with administrative data from the project’s implementing partner, a state-wide database of borrowing from all payday lenders, and to nationwide subprime credit bureau data.

Results and Policy Lessons
Analysis ongoing; results forthcoming.

Sources