Natural Disasters and Payday Lending
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There has been plenty of Hurricane Irene blogging, and some posts linking natural disasters to various aspects of law and policy (see, e.g. my colleague Ilya Somin discussing property rights and falling trees). Often, post-natural disaster economic discussion at TOTM turns to the perverse consequences of price gouging laws. This time around, the damage from the hurricane got me thinking about the issue of availability of credit. In policy debates in and around the new CFPB and its likely agenda — which is often reported to include restrictions on payday lending — I often take up the unpopular (at least in the rooms in which these debates often occur) position that while payday lenders can abuse consumers, one should think very carefully about incentives before going about restricting access to any form of consumer credit. In the case of payday lending, for example, proponents of restrictions or outright bans generally have in mind a counterfactual world in which consumers who are choosing payday loans are simply “missing out” on other forms of credit with superior terms. Often, proponents of this position rely upon a theory involving particular behavioral biases of at least some substantial fraction of borrowers who, for example, over estimate their future ability to pay off the loan. Skeptics of government-imposed restrictions on access to consumer credit (whether it be credit cards or payday lending) often argue that such restrictions do not change the underlying demand for consumer credit. Consumer demand for credit — whether for consumption smoothing purposes or in response to a natural disaster or personal income “shock” or another reason — is an important lubricant for economic growth. Restrictions do not reduce this demand at all — in fact, critics of these restrictions point out, consumers are likely to switch to the closest substitute forms of credit available to them if access to one source is foreclosed. Of course, these stories are not necessarily mutually exclusive: that is, some payday loan customers might irrationally use payday lending while better options are available while at the same time, it is the best source of credit available to other customers.

In any event, one important testable implication for the economic theories of payday lending relied upon by critics of such restrictions (including myself) is that restrictions on their use will have a negative impact on access to credit for payday lending customers (i.e. they will not be able to simply turn to better sources of credit). While most critics of government restrictions on access to consumer credit appear to recognize the potential for abuse and favor disclosure regimes and significant efforts to police and punish fraud, the idea that payday loans might generate serious economic benefits for society often appears repugnant to supporters. All of this takes me to an excellent paper that lies at the intersection of these two issues: natural disasters and the economic effects of restrictions on payday lending. The paper is Adair Morse’s Payday Lenders: Heroes or Villians. From the abstract:
I ask whether access to high-interest credit (payday loans) exacerbates or mitigates individual financial distress. Using natural disasters as an exogenous shock, I apply a propensity score matched, triple difference specification to identify a causal relationship between access-to-credit and welfare. I find that California foreclosures increase by 4.5 units per 1,000 homes in the year after a natural disaster, but the existence of payday lenders mitigates 1.0-1.3 of these foreclosures. In a placebo test for natural disasters covered by homeowner insurance, I find no payday lending mitigation effect. Lenders also mitigate larcenies, but have no effect on burglaries or vehicle thefts. My methodology demonstrates that my results apply to ordinary personal emergencies, with the caveat that not all payday loan customers borrow for emergencies.

To be sure, there are other papers with different designs that identify economic benefits from payday lending and other otherwise “disfavored” credit products. Similarly, there papers out there that use different data and a variety of research designs and identify social harms from payday lending (see here for links to a handful, and here for a recent attempt). A literature survey is available here. Nonetheless, Morse’s results remind me that consumer credit institutions — even non-traditional ones — can generate serious economic benefits in times of need and policy analysts must be careful in evaluating and weighing those benefits against potential costs when thinking about and designing restrictions that will change incentives in consumer credit markets.

Filed under: behavioral economics, behavioral economics, consumer financial protection bureau, consumer protection, contracts, cost-benefit analysis, credit cards, economics, regulation

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