

# Literature Review on Payday Lending

## Assessing Its Harms and Benefits

By Allison Freeman and Lucy Gorham

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Roberto G. Quercia, Director  
Lucy Gorham, Executive Director

## **Introduction**

In advance of the Consumer Financial Protection Bureau's beginning rulemaking on short-term, small-dollar consumer loans, the Center for Responsible Lending contacted the UNC Center for Community Capital to request a review of the academic literature on the costs and benefits of payday lending. The literature review was to have two main elements: 1) an examination of the articles claiming that payday loans harm or benefit consumers; and 2) an examination of the literature overall, including its limitations and shortcomings.

This document is the result of an extensive examination of the academic literature concerning the purported costs and benefits of payday lending. It has four sections. The first provides an introduction to payday lending, as defined in the literature. The second section reviews the literature, and it is broken into four subsections, which focus on: 1) how payday lending harms consumers, 2) how payday lending benefits consumers; 3) studies with mixed or neutral findings; 4) a few additional, relevant studies, though these do not address costs or benefits in particular. The third section of this paper looks at the academic literature on payday lending as a whole, and it is broken into three sections, which focus on: 1) methodological issues in the study of payday lending; 2) how costs and benefits have been defined across the literature; 3) what is missing from the academic study of payday lending. The fourth section of this paper offers some concluding thoughts.

## **Payday Lending Defined**

A payday loan is a short-term cash loan for which the borrower writes a personal check or provides electronic access to his/her bank account. In the case of writing a personal check, the check amount is for the value of the cash borrowed plus a finance charge. The check is usually held until the next payday – so the term of the loan will vary by borrower payday frequency, though two-weeks is the standard duration – and on that day, the total amount of loan and finance charge is due in one lump sum. The loan can be repaid in one of several ways: the borrower can pay with cash or money order to get the check back or the borrower can allow the lender to deposit the check. In the case where borrowers provide electronic access to their bank accounts, disbursement and repayment of loan and finance charge occur electronically. If a borrower cannot repay in full when the payday loan and fee are due, s/he can pay a new fee to have the loan extended to another pay period (a practice termed a “roll over”). (Plunkett and Hurtado, 2011; Noyes, 2006; Drysdale and Keest, 1999) Payday loan finance charges typically run from \$15 to \$30 per \$100 loaned; when calculated in terms of annual percentage rate (APR), for a two-week loan, this come to an APR of between 390% and 780%. (Noyes, 2006) The one exception to payday lending's unlimited APRs is for military families: in 2007, the Military Lending Act capped the APR on payday and title loans at 36% for military families.

The payday lending industry differs from traditional bank or credit union lending in several ways. First, payday lenders do not assess consumers' ability to repay: they do not run a full credit check, consider debt-to-income ratios of any sort, and do not otherwise assess borrowers' ability to repay. (Plunkett and Hurtado, 2011) However, because of the nature of the loan, borrowers must hold a bank account, have a source of income, and present identification; payday lenders do not deal with the unbanked. Second, collection practices differ from those of banks and credit unions. According to Noyes (2006), “because

payday lenders keep postdated checks or electronic access to a consumer's checking account as security, they are able to pursue collection options not available to other lenders. Many payday lenders charge bounced-check fees if consumers do not repay their loans.” In addition, in some states, depositing the bad check might lead to a civil bad check penalty, which can be three times the face value of the check. (Drysdale and Keest, 1999) In the worst case scenario where a deposited check is not sufficiently covered, payday lenders might seek repayment of principal and interest, bounced check fees, triple the check amount, and additional collection fees. (Drysdale and Keest, 1999)

One of the major concerns of fair lending advocates is the payday industry practice of rollovers, which result in borrowers paying a series of fees without ever reducing the principal amount of their loan. While a number of states have attempted to regulate such practices, the payday lending industry has come up with ways to circumvent these restrictions (hence, rollovers might be called “extensions,” “renewals,” or “new loans”). For example, where rollovers are prohibited, lenders might have borrowers redeem their checks and then immediately re-borrow the same funds and pay a new fee to do so. (Plunkett and Hurtado, 2011) In an effort to pay down their loan, some borrowers resort to using multiple payday lenders, borrowing from subsequent lenders enough to pay down the full amount of prior loans and fees; however, this refinancing practice can lead to a snowballing of the original debt as each new lender tacks his or her own fees on to the borrowing cycle and the borrower must borrow increasingly greater amounts and pay higher fees to get rid of his/her debt. (Drysdale and Keest, 1999)<sup>1</sup>

## **Payday Lending: Harmful or Beneficial?**

The academic literature is mixed as to whether payday lending benefits or harms consumers. Part of the contradictory findings are due to methodological issues in the study of payday lending, a topic which will be discussed further in this paper. Here we present an overview of the major studies that find 1) harm to consumers, 2) benefits to consumers, and 3) both or neither harm/benefits.

### **Payday Lending: Harmful to Consumers**

Melzer (2011) examines the effect of access to payday loans on families’ economic hardship. To do so, he combines data from the National Survey of America’s Families, the Bureau of Labor Statistics, the Bureau of Economic Analysis, and the U.S. Census, as well as information on the location of payday lenders. Melzer constructs a series of hardship measures, such as a delay in obtaining health care, difficulty paying one’s mortgage, and reducing or skipping meals. Access to loans is measured in two ways: geographic proximity to the border of a payday-permitting state; and changes in loan availability over time. Melzer finds no proof that payday loans alleviate hardship, and he presents evidence that, in fact, loan access leads to increased difficulty with other essential payments – e.g. mortgages, rent, and utility bills. For example, he finds that “among families with \$15,000 to \$50,000 in annual income, loan access increases the incidence of difficulty paying bills by 25%. Among adults in these families, access increases the delay of needed medical care, dental care and prescription drug purchases by a similar

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<sup>1</sup> As Drysdale and Keest (1999) put it, “to keep Lender Paul's \$115 check from bouncing, the borrower may end up writing a new check to Lender Peter for over \$130. The new loan principal is now \$115 (\$100 principal plus \$15 interest on Paul's loan), plus Lender Peter's new fee for a \$115 loan (which may be higher than the \$15 fee for a \$100 loan).”

proportion.” Melzer concludes that payday loans do not so much help households meet expenses as they create a debt burden that compromises households’ ability to meet other important expenses.

Skiba and Tobacman (2011) examine the impact of payday loans on bankruptcy and indebtedness. They do so using a four-year-long panel dataset from a payday lender; this includes the timing, size, and location of loans, as well as demographic information on individual borrowers. The authors match these data to public records on bankruptcy filings. Because “payday loan applications are approved if and only if the applicant’s credit score exceeds a fixed threshold,” these researchers are able to construct a regression discontinuity analysis comparing differences in bankruptcy rates between barely approved and barely rejected payday loan applicants with similar credit scores. The analysis reveals a doubling of Chapter 13 bankruptcy filings within two years of the first successful payday loan application, though no effect on Chapter 7 bankruptcy filings. Skiba and Tobacman find these effects are stronger on women, minorities, and homeowners. Interestingly, they also find a stronger effect on individuals who apply for loans at stores with few nearby competitors and at stores offering only payday loans (as opposed to other financial products). As they seek to explain how use of a small loan might have an effect on bankruptcy – which, as they point out, is a “cumulative financial outcome – the authors look at the effect of first-time payday loan approval on subsequent payday loan use. They find that, on average, successful first-time applicants apply for 5.1 more loans than rejected first-time applicants in the 12 months following the first application, and this results in an additional \$1,600 in loans and \$300 in interest payments. The authors conclude that their study provides evidence that access to payday loans increases personal bankruptcy rates, and that it seems to do so through a “medium-run effect that compromises borrowers’ financial stability due to repeated payment of finance charges to the payday lender.”

Carrell and Zinman (2014) set out to find the effect of payday loan access on military personnel’s job performance and retention. Their dataset includes all enlisted members of the U.S. Air Force stationed at all 67 domestic Air Force bases (so, in 35 states) between 1996-2001 or 1996-2007 (the time period depends on the outcome measured). Their measures of job readiness, performance, and retention include three things: the presence of an Unfavorable Information File, reenlistment eligibility, and reenlistment itself. Payday loan access is just one variable they incorporate in their models, and it is measured by within-state variation in state lending laws. The analysis uncovers “some evidence that payday loan access adversely affects job performance and readiness. Access significantly increases the likelihood that an airman is ineligible to re-enlist by 1.1 percentage points (i.e., by 3.9%).” They also find a comparable decline in reenlistment. Payday loan access also “significantly increases the likelihood that an airman is sanctioned for critically poor readiness by 0.2 percentage points (5.3%).”

As part of their examination into the causes of involuntary bank account closure, Campbell, Martinez-Jerez, and Tufano (2012) assess the effect of access to payday loans. They do so using a national database, the ChexSystems, which receives information on involuntary account closures from about 90% of U.S. commercial financial institutions. They pair county-level closure data from 1999 to 2006 with demographic, economic, and industry data. Access to payday loans is defined in two ways: first, the authors calculate the number of payday lenders per 1,000 people in a county and use this as a proxy for supply; second, they compare the rates of involuntary closures for Georgia counties before and after that state’s ban on payday lending to those of counties in states bordering Georgia. Campbell, Martinez-Jerez, and Tufano find that the effect of the number of payday lenders is positive and significant: “a one

standard deviation increase in the per-capita number of payday lending establishments is associated with an increase in closures relative to the mean of approximately 8.61%.” As concerns their examination of the effect on involuntary account closures following the ban on payday lending in Georgia, they find that “relative to counties in neighboring states [that still allowed payday lending], the rate of involuntary closures declined after the payday lending ban.”

A snapshot summary of the articles documenting payday lending’s harm to consumers is provided here:

<b>Author/s (year)</b>	<b>Dependent Variable</b>	<b>Independent Variable</b>
Melzer (2011)	Economic Hardship (delay healthcare, skip meals)	Access to payday loans (geographic proximity; loan availability over time)
Skiba and Tobacman (2011)	Bankruptcy filings and indebtedness	Actual payday loan use
Carrell and Zinman (2014)	Military personnel's job readiness/ performance/retention	Within-state variation in state lending laws
Campbell, Martinez-Jerez, Tufano (2012)	Involuntary account closure	Access to payday loans (# lenders/1000 people; GA payday ban)

At least one article doesn’t set out to establish the costs or benefits of payday lending, but finds individual-level costs nevertheless. Agarwal, Skiba, and Tobacman (2009) do not set out to assess the effect of payday borrowing on consumers’ lives. Rather, they hope to examine “consumers' effectiveness at prioritizing use of their lowest-cost credit option” by assessing the choice between borrowing on a credit card and using a payday loan. They use a unique dataset that merges loan records from a large payday lender with transaction and credit records from a financial institution offering checking accounts, credit cards, home loans and lines of credit, and auto loans. They discover that most payday borrowers who hold credit cards “have substantial credit card liquidity on the days they take out their payday loans,” and they determine that the typical credit card holder could have saved close to \$200 had she borrowed up to her credit card limits rather than use payday loans. Particularly important for this current literature review, these researchers also determine that “taking out a payday loan predicts nearly a doubling in the probability of serious credit card delinquency over the next year.”

Another paper, Morgan, Strain, and Seblani (2012), finds more benefits than harms associated with payday borrowing (for this reason, the article is discussed in depth in the next section of this literature review). However, as these researchers assess the relationship between access to payday loans and three outcomes – overdrafts, bankruptcy, and household complaints against lenders and debt collectors – they find evidence that Chapter 13 bankruptcy rates decrease after bans on payday lending. So although their most robust findings concern the increased costs to consumers of banning payday borrowing, it bears mentioning here that they also find evidence which suggests a link between payday borrowing and the negative outcome of filing for bankruptcy.

## **Payday Lending: Beneficial to Consumers**

Fitzpatrick and Coleman-Jensen (2014) examine the relationship between payday loan access and food insecurity and inadequacy. The authors examine these relationships using a sample of nonelderly households from both the December 2008 and January 2009 Current Population Surveys. Their dependent variables include two measures of “consumption inadequacy”: 1) food-insecurity, which they define as a state in which households are, at times, unable to purchase adequate food for one or more members because of insufficient funds; and 2) food-inadequacy, which they define as households reporting that they have to increase their spending in order to meet their food needs. Their two independent variables concerning payday lending are state laws and regulations that inhibit access to payday loans and household payday loan use over the prior 12 months. The authors acknowledge that the relationship between the use of such loans and food security is ambiguous: while short-term consumer credit provides funds that might improve food security, if such debt builds up over time, ultimately, the servicing of this debt could have a negative effect on food spending. While the authors don’t set out to show that payday loans are “beneficial” to consumers, their findings could be used in support of such arguments. Their probit regression analysis reveals that “state legislation limiting access to payday loans increases the prevalence of [the] marginal food security measure by 1.4 percentage points and the probability of reporting that more money is needed for food (food inadequacy) by 2.3 percentage points.” The authors suggest that payday loans help protect some households from food insecurity, and conclude “that many households that are at risk for food insecurity face an unmet need for short-term credit and that improved credit access could reduce food insecurity and improve wellbeing.”

Zinman (2010) assesses the harm to consumers when payday lending is restricted. Zinman’s data consist of before- and after-restriction panel data from a sample of payday borrowers from Oregon, where limits went into effect in 2007,<sup>2</sup> and Washington, where no such restriction existed. Using these data he constructs difference-in-differences estimates of the effects of the restrictions on three aspects of borrowers’ lives: their borrowing behavior, their employment status (the assumption being that payday loans are used to finance emergency needs, such as auto repairs, that allow borrowers to work), and their subjective assessment of their financial wellbeing. Zinman finds that “borrowing fell in Oregon relative to Washington, with former payday borrowers shifting partially into plausibly inferior substitutes: bank overdrafts and late bill payment. Additional evidence suggests that restricting access caused deterioration in the overall financial condition of Oregon households. Overall the results are consistent with restricted access harming, not helping, consumers on average.” However, Zinman qualifies his findings by pointing out that the longer-term effects of restricting payday lending in Oregon may differ from the effects over the five-month period his data come from. He notes that the benefits of borrowers productive (e.g. investment) loan use and counterproductive (e.g. splurges) loan use might take more time to be revealed. Also, he points out that those borrowers in Oregon who were still accessing payday loans were doing so under more favorable terms than their Washington counterparts, and any benefits from these differences might also take time to manifest.

Adding to the literature on the harms of restricting access to payday loans are Morgan and Strain (2008). They examine changes in household economic wellbeing in GA and NC after payday bans were put in

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<sup>2</sup> At that time, the maximum combined finance charges and fees on loans under \$50,000 was capped at \$10 per \$100 and the minimum loan term was set at 31 days.

place in 2004 and 2005. They assess three measures of economic wellbeing: patterns of bounced checks (using data from Federal Reserve check processing centers), complaints against lenders and debt collectors (using data on filings with the Federal Trade Commission), and federal bankruptcy filings. They conduct difference-in-differences and multivariate regression analyses to examine changes in household welfare following the payday bans. According to these authors, “relative to other states, households in Georgia bounced more checks after the ban, complained more about lenders and debt collectors, and were more likely to file for bankruptcy under Chapter 7. The changes are substantial. On average, the Federal Reserve check processing center in Atlanta returned 1.2 million more checks per year after the ban. At \$30 per item, depositors paid an extra \$36 million per year in bounced check fees after the ban. Complaints against debt collectors by Georgians, the state with the highest rate of complaints to begin with, rose 64 percent compared to before the ban, relative to other states. Preliminary results for North Carolina are very similar.” In an update of this paper, Morgan, Strain and Seblani (2012) find evidence that Chapter 13 bankruptcy rates decrease after payday credit bans, but they also find that complaints against lenders and debt collectors increase. In fact, their most robust finding is that both the number of returned checks and the overdraft fees earned by banks increase after payday credit bans. Because bouncing a check can be more costly than a payday loan, these authors suggest that access to payday loans helps households avoid more expensive alternatives.

Morse (2011) assesses whether access to payday loans exacerbates or alleviates financial distress following natural disasters. To do so, Morse uses data from California for the years 1996 to 2002 to conduct a propensity score matched, triple-difference analysis, using natural disasters as an exogenous shock. As in most studies, access to payday loans is defined geographically (here, with zip-code-level mapping of payday lenders). Morse examines how the presence of payday lenders affected local foreclosure and small-property crime rates following natural disasters. Her results “indicate that payday lenders offer a positive service to individuals facing financial distress. Natural disasters increase foreclosures by 4.5 units per 1,000 homes in the year following the event, but payday lenders mitigate 1.0 to 1.3 units of this increase.” She also concludes that payday lenders mitigate larcenies (though not burglaries or vehicle thefts), by reducing individuals’ need to resort to petty crime to alleviate financial distress.

Hynes (2012) uses county-level data from 1998 through 2009 in a series of regression analyses to assess the relationship between the legalization of payday lending and bankruptcy filing rates, property crime rates, and the rate at which landlords sue tenants for eviction (despite these different dependent variables, the focus of his article is almost exclusively on bankruptcy). Hynes is curious about whether the legalization of payday lending will result in an increase in financial distress, and whether – given the assertion that payday lenders target minorities and members of the military, in particular – these changes will be more pronounced in areas with large military or minority populations. He finds that bankruptcy filings do not increase after states legalize payday lending, and that filings tend to fall in counties with a greater military presence. Hynes concludes that, “consistent with the beneficial view of payday lending, this article finds that as states legalize payday lending the bankruptcy filing rate tends to fall in counties with large military populations. While this result is robust against a variety of alternative specifications, I failed to find a statistically significant effect in areas with large minority populations.” As for the relationship between payday and his other measures of financial distress, “the results are, again, more consistent with the beneficial view of payday lending. The basic specifications suggest that the crime rate

(measured by all property crimes, burglary, and larceny) tends to fall after the legalization of payday lending.

A snapshot summary of the articles that find payday lending benefits consumers is provided here:<sup>3</sup>

<b>Author/s (year)</b>	<b>Dependent Variable</b>	<b>Independent Variable</b>
Fitzpatrick and Coleman-Jensen (2014)	Food insecurity/inadequacy	State limits on access to payday loans; household use of payday loans
Zinman (2010)	Borrowing behavior, employment status, and subjective assessment of financial wellbeing	State limits on access to payday loans (OR v. WA)
Morgan and Strain (2008)/ Morgan, Strain and Seblani (2012)	Bounced check patterns, complaints against lenders/debt collectors, bankruptcy	State-level changes over time in whether or not payday lending was permitted
Morse (2011)	Local rates of foreclosure and petty crime following natural disasters	Zip-code-level location of payday lenders
Hynes (2012)	Bankruptcy filing rates, property crime rates, and the rate at which landlords sue tenants for eviction	Changes in state laws regulating payday lending across time

It bears noting that one additional study, Priestley (2014), has found that payday borrowing has benefits for consumers. Using data from three large payday lenders, Priestley (2014) examines the effect on consumer credit scores<sup>4</sup> of two things: 1) differences in payday rollover behavior; and 2) state-level rollover regulation. She finds that “sustained use of payday loans has a net positive impact on consumer credit scores, and that state-law restrictions on the duration of payday-loan borrowing have a net negative impact.” Because this article has already been reviewed at length by the Center for Responsible Lending, an in-depth review is not included here.

### **Payday Lending: Mixed Findings**

Wilson et al. (2010) employ experimental economics using a lab-based computer simulation to examine whether access to payday loans improves or worsens people’s financial wellbeing; they also test the extent to which use of payday loans affects participants’ ability to survive financially. Their computer-experiment provided all subjects with a fixed income and with the same distribution of anticipated

<sup>3</sup> Karlan and Zinman (2010) have conducted research in South Africa that suggests there might be benefits to expanding access to “expensive consumer credit.” However, the loans in their study differ from American payday loans in three important ways: they were offered by a lender who assessed borrowers’ ability to repay; they were four-months long in duration; the interest rate was high, but was capped at 200%. Because these loans differ so greatly from U.S. payday loans, the article is not included in the current review.

<sup>4</sup> As mentioned elsewhere in this literature review, payday borrowing has only an indirect impact on credit score, since payday loans are not usually reported to the national credit bureaus. Priestley herself acknowledges this: “any correlation between payday-loan activity and credit-score dynamics lacks a direct causal relationship.”

monthly expenditures, optional consumption items, and unanticipated shocks. One group of participants had access to payday loans (the “loan” treatment) as they attempted to balance their (virtual) budgets while the other group of participants did not (the “no loan” treatment). The researchers then used a Cox proportional hazards model to determine that payday loans helped subjects absorb unexpected expenses, and that the loans thereby helped them survive financially. However, the research also revealed that subjects whose demand for payday loans exceeded a certain threshold were at greater financial risk than subjects who did not have access to payday loans. These researchers determine that “a sparing use of loans enhances the survivability of the subject relative to the *No Loan* treatment. The model predicts that a subject taking out ten or fewer loans in the *Loan* treatment has a lower hazard rate than a corresponding subject in the *No Loan* treatment. However, taking out more than ten loans puts the subjects at a greater risk than a corresponding subject in the *No Loan* treatment.”

Bhutta (2014) combines individual credit record data from Equifax and Census data on payday lender store locations to assess the effect of geographic and time-based differences in access to payday loans on individual financial health (credit scores, score changes, delinquency, etc.) His difference-in-differences analyses reveal little effect of payday loans on credit scores,<sup>5</sup> new delinquencies, or the likelihood of overdrawing credit lines. According to Bhutta, there is “little evidence that payday loans substantively affect credit scores, or the likelihood of large score declines, delinquency or having other debt-management problems as indicated by exceeding credit card limits.”

In order to assess the relationship between payday loan use and individual financial wellbeing, Bhutta, Skiba, and Tobacman (2013) merge three types of data: one payday lending chain’s application records from between January 2001 and August 2004, a decade of detailed credit account information from the Federal Reserve Bank of New York’s Consumer Credit Panel, and Equifax credit risk scores. They examine the relationship between individual payday loan use and credit score, an indirect relationship, since payday loans only affect credit score insofar as they affect one’s ability to meet other financial obligations. They use a similar approach to Skiba and Tobacman (2011) and create a regression discontinuity design that compares applicants who were similarly qualified to borrow (in terms of Teletrack application scores) but who were either barely approved or barely rejected for a loan. They find that “the long-run effect of payday borrowing on credit scores and other measures of financial wellbeing is close to zero.” In short, “the path of traditional credit scores after initial payday loan applications differ very little between those barely accepted and those barely rejected for payday loans.” They conclude that “payday applicants have very poor credit, and payday loan access appears irrelevant to its repair or further deterioration.” They also find “no evidence that payday loans affect other credit record outcomes, such as delinquencies, or that payday loans have an effect within various subgroups such as younger applicants. Together these findings suggest that regulatory changes in access to payday loans would have limited average effects (positive or negative) on financial wellbeing.”

It bears noting that Mann (2014) has conducted analysis that reveals little effect of payday borrowing on borrowers’ financial health. In this analysis, he uses a difference-in-differences method to compare credit score changes over time between those who do and do not default on their payday loans. He finds little

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<sup>5</sup> Any effect would be indirect, according to Bhutta, because “payday lenders rarely report to the national credit bureaus. Rather, payday loans can affect credit scores indirectly to the extent that such loans either improve or undermine consumers’ ability to manage cash flow and meet their financial obligations in general.”

difference in credit score changes between these groups of borrowers. Because Mann’s article has already been reviewed at length by the Center for Responsible Lending, an in-depth review is not included here.

### **Payday Lending: Additional Studies of Relevance**

Several studies aren’t intended to assess the costs and benefits of payday lending, so find neither type of outcome. However, because they provide some relevant findings about consumers and consumer behavior, they might help inform legislative efforts aimed at reducing reliance on payday loans. We include an overview of two of them here.

Bertrand and Morse (2011) examine how information disclosure affects the choice to take out a payday loan. The authors perform a randomized field trial to determine whether the ways that information about the costs of payday lending are presented to borrowers affect individuals’ decisions to continue borrowing from payday lenders. In general, the price schedules posted in payday lenders offices show the cost of credit as a fee per \$100, for example, \$15 per \$100. In their experiment, these researchers present payday costs in one of three ways: 1) through disclosure of the payday loan’s APR and by comparing this rate to the APR on a car loan, credit card, and subprime mortgage; 2) by presenting the dollar-cost of accumulated fees for having a \$300 payday loan outstanding for two weeks, one month, or three months and then comparing this with the fees one would pay for the same amount on a credit card; and 3) by presenting borrowers with the “typical repayment profile for payday borrowers, reported in a frequency format, for example, the frequency distribution of time to repayment of a given loan.” The researchers discover that individuals who received the second intervention – the dollar cost of accumulated payday fees and how these compare with the cost of borrowing on a credit card – are 11% less likely to borrow from the payday lender in the pay cycles that follow the intervention. All three treatments result in a reduction in amounts borrowed in future, with those who received the second, dollar-cost intervention reducing their borrowing most greatly, by 23% relative to the control group (no intervention).

As they set out to determine the relationship between payday loan use and individual financial wellbeing, Bhutta, Skiba, and Tobacman (2013) reveal other interesting findings about payday borrowers. Again, as detailed in the previous section, these researchers merged three types of data: one payday lending chain’s application records from between January 2001 and August 2004, a decade of detailed credit account information from the Federal Reserve Bank of New York’s Consumer Credit Panel, and Equifax credit risk scores. In terms of applicants’ financial wellbeing at the time of seeking a payday loan, the researchers find that payday loan applications occur “when consumers’ access to liquidity from mainstream creditors is lowest.... Nearly 80 percent of payday applicants have no credit available on credit cards and 90 percent have less than \$300 of credit available on credit cards just before applying for a payday loan. In addition, measures of shopping for—and failing to obtain—cheaper, mainstream credit surge around the time initial payday loan applications occur, especially for those with few existing credit accounts.” In terms of payday applicants’ financial wellbeing overall, they find “extremely persistent weakness in credit record attributes among payday applicants. Payday applicants’ average credit scores are 1.5 standard deviations below the general population average throughout the entire ten-year observation span. Payday applicants fall behind on payments and apply for new credit accounts much more frequently than the general population, long before and long after their initial payday loan application.”

## **A Broader Consideration of the Academic Literature on Payday Lending**

This section steps back from individual studies of payday lending to offer an overview of the academic literature reviewed herein. We look in particular at methodological issues in the study of payday lending, how payday's "costs" and "benefits" have been defined across the literature, and then assess what has been missing from the study of payday lending.

### **Methodological Issues in the Study of Payday Lending**

Research into the effects of payday lending is limited by several factors. The most pressing limitation is that there are few publicly available datasets on payday borrowing. As a result, almost none of the studies in this literature review incorporate household-level data on payday loan use. Instead, most studies focus on "access" to payday loans: either geographic location of lenders; legal changes over time that affect the availability of payday loans; or comparisons between proximate places that allow/disallow payday lending. Regional comparisons of payday "access" are problematic because regions can differ along many measures, beyond their regulation of payday lending: these studies suffer from an inability to firmly identify payday "access" in particular as the cause of their findings. (Fitzpatrick and Coleman-Jensen, 2014)

Another problem stemming from the lack of data on individual use of payday loans is that analyses incorporating broader measures of "access" lead to findings that are necessarily sweeping and imprecise, examining average effects rather than individual effects. Melzer (2011) discusses this in his work. He does not incorporate actual household use of payday loans in his study, but rather includes more sweeping measures of "access" (geographic/temporal) to payday loans. As Melzer notes, "this exercise is necessarily imprecise, owing to lack of data on the proportion of households and adults that borrow in the years and income groups considered in this study. Based on historical estimates of payday borrowing, [he assumes] that roughly 10% of sample households borrow and 6% of sample adults borrow."

And, unfortunately, even those studies that incorporate actual borrower-level data on payday loan use have suffered from problems of generalizability. For the most part, the data used in these studies come from just one payday lending company: this is the case for of Agarwal, Skiba, and Tobacman (2009) and Skiba and Tobacman (2011). As Fitzpatrick and Coleman-Jensen (2014) point out, this will limit generalizability of the studies' findings.

Another issue with payday lending studies is that it is impossible to understand the link between payday lending and the dependent variable of interest without precise information on the timing of the events under consideration. Fitzpatrick and Coleman-Jensen (2014) point out that this is one of the limitations of their own study: without detailed information on when borrowing occurred relative to the variable of interest (in their article, food security/inadequacy), there is no way to rule out that payday borrowing may have occurred *after* whatever "harm" is measured. In short, without a clear sequence of events, it is impossible to make a claim as to what might have caused what.

Broader macroeconomic conditions can also affect analyses of payday lending. Studies that rely upon data from a period of economic decline, for example, might result in findings that are specific to that time period. Fitzpatrick and Coleman-Jensen (2014) admit that this issue might limit the reach of their findings: “[our] research largely relies on cross-sectional variation and our results could be sensitive to the unique economic circumstances occurring in 2008.” And even where panel data are used to track the same households over time through a variety of economic conditions, if the data are not captured over a long enough time frame, they will not allow for rigorous analysis of change over time. Such is the case with the work of Zinman (2010), who acknowledges that the short duration of his study (five months) might limit the reach of his findings: “the longer-run impacts of policy initiatives to restrict credit access might differ from the five-month results.”

Finally, there are limits on the generalizability of lab-based studies of payday lending (studies from the emerging field of experimental economics). Such is the case for Wilson et al. (2010), who admit: “at the outset we also note that our findings, as with those with any empirical study in the field or laboratory, are inherently specific to the population under study.” In short, college students in a lab probably don’t behave the same as financially straitened individuals who are seeking short-term credit.

### **How Costs and Benefits Have Been Defined in the Literature**

As researchers examine the costs and benefits of payday lending, they analyze the effects of such borrowing on a number of outcomes.<sup>6</sup> This list provides an overview of how the academic literature reviewed in this paper defines the costs and benefits of payday lending:

1. Borrowers’ shifting into plausibly inferior (more expensive) substitutes (Zinman, 2010)
2. Borrowers’ experiencing unemployment (Zinman, 2010)
3. Borrowers’ having a negative assessment of their financial situations (Zinman, 2010)
4. Patterns of bounced checks (Morgan and Strain, 2008; Morgan, Strain, and Seblani, 2012)
5. Bank account closure (Campbell, Martinez-Jerez, and Tufano, 2012)
6. Complaints against lenders and debt collectors (Morgan and Strain, 2008; Morgan, Strain, and Seblani, 2012)
7. Bankruptcy filings (Morgan and Strain, 2008; Morgan, Strain, and Seblani, 2012; Skiba and Tobacman, 2011; Hynes, 2012)
8. Indebtedness (Skiba and Tobacman, 2011)
9. Postponement of medical care (Melzer, 2011)
10. Difficulty paying bills (Melzer, 2011; Bhutta, 2014)
11. Foreclosure/having to move (Morse, 2011; Melzer, 2011)
12. Food-inadequacy and/or food-insecurity (Melzer, 2011; Fitzpatrick and Coleman-Jensen, 2014)
13. Reduced phone service (Melzer, 2011)
14. Job readiness, performance, and retention (Carrell and Zinman, 2014)
15. Property crime rates (Hynes, 2012; Morse, 2011)
16. Landlord-tenant disputes (Hynes, 2012)
17. Credit score (Bhutta, 2014; Bhutta, Skiba, and Tobacman, 2013; Priestley, 2014; Mann, 2014)

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<sup>6</sup> Some of the measures in this list – those of Melzer, for example – are aggregated into broader measures of hardship, i.e. not all variables in the list show up in the studies as distinct dependent variables.

## What is Missing from the Academic Literature on Payday Lending

Because of limited-to-non-existent access to individual-level data on payday borrowing, the academic literature on payday lending lacks a rigorous examination of *who* uses payday loans and what effect that use has on borrowers' lives. As researchers attempt to define who uses payday loans, most roads lead back to descriptive analysis of who uses payday loans (and most studies cite research by the Center for Responsible Lending). Beyond this, there has been little examination of the systematic differences between payday borrowers and the broader banked<sup>7</sup> population. There is a real need for such analysis in order to give greater weight to the claims that payday lending disproportionately harms lower-income and minority borrowers and members of the military.

A few of the articles reviewed in this paper do include demographic variables in their analysis. Skiba and Tobacman (2011), who use individual-borrower data from a payday lending company, include demographic variables in their analysis of the relationship between payday lending and bankruptcy filings and indebtedness. They found a doubling of Chapter 13 bankruptcy filings within two years of the first successful payday loan application, though no effect on Chapter 7 bankruptcy filings. Interestingly, their analysis reveals that the effects are stronger on women and minorities.

Hynes (2012) considers both minorities and members of the military in his analysis of the relationship between the legalization of payday lending and bankruptcy filing rates, property crime rates, and the rate at which landlords sue tenants for eviction. Unfortunately, he is unable to examine demographics at the individual-level, but rather maintains a geographic focus in his analysis. He finds that "as states legalize payday lending the bankruptcy filing rate tends to fall in counties with large military populations. While this result is robust against a variety of alternative specifications, [he] failed to find a statistically significant effect in areas with large minority populations."

Carrell and Zinman (2014) create their analysis so that it focuses specifically on the impact of payday borrowing on military members' job readiness, performance, and retention. Their analysis reveals evidence that payday loan access negatively affects job performance and readiness. However, because the authors' payday lending variable is captured by within-state variation in state lending laws, their work suffers from the lack of precision inherent in all studies focused on average rather than individual effects.

One area where analysis of payday lending has made some strides in attempting to understand systematic differences in payday lending is in the examination of location decisions by lenders themselves. These articles have attempted to understand, for example, payday's targeting of minority areas. Because these studies do not focus specifically on "harm," they are beyond the scope of this literature review. Interested parties might see Cohen-Cole (2011) or King et al. (2005).

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<sup>7</sup> Because payday borrowers have to hold a checking/transaction account in order to obtain a loan, all payday borrowers are banked.

## Conclusion

The literature on payday lending implies that use of short-term, high-interest-rate consumer credit might have any number of negative effects on borrowers' lives. Suggested negative outcomes include: poor job performance, foreclosure, forced moving, foregoing or curtailing necessary expenditures (for food, health care, etc.), aggravating indebtedness, difficulty in servicing overall debt, bankruptcy, and an indirect negative effect on credit score.

Researchers also suggest a number of positive outcomes from payday borrowing, including avoidance of more expensive substitutes (bounced checks, for example), avoidance of job loss, avoidance of bank account closure, avoidance of complaints against lenders and debt collectors, avoidance of property crimes, avoidance of landlord-tenant disputes, and improvement in credit scores. It is interesting to note that only the last item in this list is a true "benefit" (though, as the Center for Responsible Lending's analysis of Mann (2014) and Priestley (2014) makes clear, the jury is still well out on the relationship between payday borrowing and credit score improvements). All of the other "perks" of payday lending are really the avoidance of other bad things, and most of those things stem from people not having sufficient money in their lives.

It is clear that those who use payday loans need access to short-term, small-dollar credit. With growing wage and income inequality and in the absence of living-wage jobs, people are bound to continue to need short-term, small-dollar loans to smooth consumption as unexpected expenses and unanticipated drops in income arise. The question going forward is not whether short-term consumer credit should be allowed, but rather how it might best be structured to minimize harm and maximize benefit to consumers and still generate a reasonable return for the institutions that offer it.

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UNC Center for Community Capital  
The University of North Carolina at Chapel Hill  
1700 Martin Luther King Blvd | Campus Box 3452, Suite 129  
Chapel Hill NC 27599-3452 | (877) 783-2359 | (919) 843-2140  
[communitycapital@unc.edu](mailto:communitycapital@unc.edu) | [www.ccc.unc.edu](http://www.ccc.unc.edu)

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