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Payday Loans: Bandage or Trap

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Payday Loans:

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by

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Introduction

The payday loan industry, in its modern form, seemed to have popped up out of nowhere in the late twentieth century, and lawmakers are still scrambling to find-out the best way to regulate it while payday lenders simultaneously seek to find the best way to avoid regulation. There are fierce arguments for and against payday lending. Detractors say these institutions force the most vulnerable in society into an uncontrollable cycle of indebtedness, and proponents claim that these loans are the lesser of many other evils and simply carry out the will of the free market. This paper will seek to provide the reader with a historical background and legal context of how the modern era of payday lending has come to be, give an in-depth discussion of the benefits and draw-backs of allowing payday lenders to legally operate, and perform data analysis to determine the effects of payday lending on bankruptcy rates.

Background

To fully understand the payday lending industry in its entirety, it is important to know how it became so prominent in many parts of the United States. Payday loans are part of a larger group of alternative financial services. These include "payday loans, rent-to-own financing, pawnshops, refund anticipation loans and title loans (Kim, Kyoung Tae)." However, even in this industry, Payday loans are unique due to the lack of collateral, making them riskier for the lender. However, the lender does not bear the risk alone. Instead, the borrower is the one that is forced to bear a large part of this risk in the form of astronomical interest rates.

People of all social classes need access to a line of credit. Of course, these different classes need it for different reasons. Higher classes may use it for purposes that are beneficial to them, such as buying a new house or making an investment. These are beneficial to the wellbeing of the borrower, but not essential at a moment's notice. On the other hand, less wealthy individuals are more likely to need credit to bail themselves out of emergencies, making them comparatively more desperate for immediate cash.

In 2017, Champlain College's Center for Financial Literacy graded each state and Washington D.C. on its financial literacy education provided to graduating high-school students. Out of all 51, only five states obtained an "A," and 15 received a "D" or "F." With the education system failing so many of its students, it is no surprise that people could fall into a cycle of indebtedness. In many states it is the burden of the parents to teach their kids financial basics. This perpetuates a cycle of poverty that dooms those who come from lines of financially uneducated individuals to repeat the same mistakes as their predecessors. When you combine this lack of financial literacy with a heavy demand for quick cash, it enables many financial institutions to charge exorbitant interest rates.

While the strings attached to these short-term loans could be looked at by some as a contract like any other between adults, others look at it as a scheme to take advantage of the poor. There is a historical precedent for the latter view; laws have been on the books since ancient times, even being ingrained in some religious texts. All of the Abrahamic religions have prohibited usury at some point or another, and even the Buddhist principle of right livelihood is perceived to be anti-usury. These laws and beliefs have tried to negate the amount of advantage that people and institutions that have money can take over people who do not have it. In the case of the United States, usury laws have been in place to varying degrees since the colonial period (Rockoff, Hugh). It was not until relatively recently that they have begun to disappear.

Usury laws allowed loan sharks to take advantage of gaps in the market that legal businesses couldn't satisfy. In the early 1900's, these "Salary Lenders" would charge high interest rates to the people who could afford it least and use brutal and humiliating means to enforce collection ("A Short History of Payday Lending Law.") The Uniform Small Loan Laws passed throughout the early part of the 21st century sought to change this by driving illegal lenders out of business. "The most feasible and desirable method seems to be the introduction of commercial capital into the small loan field in sufficient quantities to satisfy the need for small loans at a rate of interest both fair to both borrower and lender, and to eliminate the loan shark evil by competition rather than by restriction ("The Uniform Small Loan Law")." The goal was to find the balance where reputable small lenders could make enough of a profit to stay in business, but not enough to take advantage of their customers. This law would theoretically kill two birds with one stone by eliminating the loan shark industry and protecting borrowers. This act concluded that a three and a half percent monthly interest rate was fair for both parties and the loan amount should not exceed $300 ("The Uniform Small Loan Law.") While some states that adopted the law edited the interest rates a bit, the spirit of the law remained the same throughout the states that were to adopt the law, and this put the yearly annual percentage rates for states adopting the law between 18% and 42% ("A Short History of Payday Lending Law"). These rates were higher than normal usury rates, but still far less than Salary Lenders' rates. In total, 34 states ended up passing versions of the Uniform Small Loan Law in the first half of the 20th century (Why Cap Small Loans at 36%.).

In the second half of the twentieth century, the landscape for lending began to change significantly. Banks grew across state borders, and some were able to operate on a national scale. This opened the door to banks being able to take advantage of the National Bank act of 1864

(The Supreme Court of Minnesota). Technology began to change the financial landscape faster than regulations could adequately adjust, and huge gains were to be made exploiting archaic laws. The national bank act of 1864 allowed banks to charge interest rates based on the location of the bank and not based on the location of the customer. This war-time act passed over a century earlier in order to finance the Union's war effort would prove to start a cascade of unintended consequences. Credit cards issued by a bank in one state with more lenient usury laws could issue wherever they pleased. Of course, the writers of the law did not have the faintest idea of what a credit card was, but the law still applied.

This came to a head in 1978, when The Marquette National Bank of Minneapolis took legal action against The First National Bank of Omaha. The Nebraskan bank was enrolling Minnesotans in its BankAmericard program. The Minnesotan Bank could charge a $15 annual fee but could not charge as high of interest rates as the Bank of Omaha because of Minnesota's usury laws, even though they were effectively giving the same service in the same location. An annual fee is a much more concrete concept to people seeking to apply for credit cards, especially since people in the process of signing up for credit cards often intend to pay them off before interest even takes effect, regardless as to whether or not that will actually be the case. This gave the Bank of Omaha an advantage over the Bank of Minneapolis, at least in the eyes of the Minnesotan Bank. In the end, the court upheld the Bank of Omaha's right to "export" their interest rates under the National Bank act of 1864, setting a legal precedent in the process. While the Supreme Court of Minnesota addressed the fact that this made state-level usury laws increasingly worthless as the popularity of credit cards grew, there was nothing the court could do about it. They came to the conclusion that something probably needed to be altered about the banking system, but their hands were tied, because it was not their authority to make these changes. They stated, “the protection of state usury laws is an issue of legislative policy, and any plea to alter §85 to further that end is better addressed to the wisdom of Congress than to the judgment of this Court (The Supreme Court of Minnesota).”

The issue of interest rate “exportation” opened the door to further exploitation of the dated laws concerning interstate banking. At this point, usury laws offered little protection to citizens of any state. Credit card companies could set up shop in states like South Dakota or Delaware and export usurious interest rates all around the country. There was little economic benefit for maintaining the usury laws, so this prompted many states to drop or loosen the laws in order to attract financial businesses. The rise in states choosing to relax their usury laws allowed credit to not only be issued to financially secure prospects but opened a world of high interest borrowing to riskier cases as well.

This shifting financial landscape would contribute to the rise to the payday lending industry as it is known today, but the story is far from over. In the 1980’s and early 1990’s, a convergence of macroeconomic and regulatory factors led to a banking crisis. It is reported that 1,617 banks failed during this crisis in the period from 1980 to 1994. 1,043 thrift banks closed their doors from 1986 to 1995 (Summa, John). The wholesale destruction of these small banks resulted in small communities across the united states being underbanked and losing access to fast and affordable credit. This gap in the market combined with the deregulation of usury laws primed the financial market for a hostile takeover by payday lenders.

The way payday loans work is fairly simple. Little is required of the borrower other than “proper identification, proof of income, and a checking account (“Payday Loans: Time for Review”).” Other than that, the only requirement is a post-dated check or permission for electronic withdrawal for the principal plus the fee. If the borrower does not have the means to pay off the loan when it matures, they have the option to roll it over by paying the interest fee and letting it accrue more interest for the next pay period ("Payday Loans: Time for Review".)

The first modern payday lending location, Check Into Cash, was founded by an "entrepreneur and philanthropist" by the name of Allan Jones in 1993 ("About Check Into Cash"). Since the first store opened, the industry has grown at a phenomenal rate. In 2014, a mere 21 years after the industry was established, there were more than 20,000 payday lending locations across the country ("Payday Loans: Time for Review").

Purported Benefits of Payday Lending

Although it is easy to dismiss payday lenders as a purely malevolent force with only the intention of preying on the most vulnerable, there are some pretty compelling arguments for it, at least in the way the financial system currently functions. Much of the logic behind the pro-payday lending lobby concerns what happens outside of the boundaries of what can be effectively regulated. This was certainly taken into consideration when the usury laws of the early 20th century were being drafted; "So long as a need exists for small loans, it will be met, and if the need cannot be met lawfully, the law will be evaded ("The Uniform Small Loan Law")." This is an interesting argument that illustrates the delicate balance that state governments have to face. Is it better to keep the unpleasant aspects of society in sight so that they can be reeled in if they wander too far astray, or is it better to sweep them under the rug and feel that the right thing was done even though everyone knows it is still there, just in hiding. By the logic of this argument, payday loans are the lesser of two evils, and in order to remedy the plight of the poor, a new and inventive solution would have to be offered rather than an outright ban.

Another argument in defense of payday lending has to do with the way interest rates themselves are perceived and once again falls under the umbrella of the lesser of two evils argument. Most people who use payday lenders do not think of these fees for fast cash in terms of annualized percentage rate. The duration of the loan is so short, usually until the next paycheck, that yearly interest is not even a consideration. If these terms were thought of as triple digit APR's, it would be far less attractive. Instead, they are marketed and perceived as a fee of twenty or thirty dollars for borrowing money today. From a practical standpoint, it is the same thing, but from a psychological standpoint it is completely different. One could look at this marketing as deceptive, but it only works because there is some truth behind it.

Borrowers think that if they borrow a few hundred dollars in the present, at the small expense of fifteen to thirty dollars, they can avoid paying a range of other fees from separate sources. Overdraft fees, which on average cost about $35, late fees, and reconnection fees on utilities and services have the potential to be much more than the fee on a payday loan, not to mention the long term effects that a credit hit would entail (Silva, Derek.) If the borrower does not have a better credit option, payday loans make the most economic sense in this scenario ("The Argument in Favor of Payday Lending.") Even though this is a hypothetical scenario, it is a reality for many Americans. A Federal reserve report for 2018 found that, "if faced with an unexpected expense of $400, 61 percent of adults say they would cover it with, cash, savings, or a credit card paid off at the next statement… 27 percent would borrow or sell something to pay for the expense, and 12 percent would not be able to cover the expense at all." That leaves approximately 30.5 million American adults with no option but usurious lenders to cover unforeseen expenses.

Lastly, if you believe in the free-market's ability to determine what businesses should be viable, it makes no sense to ban or restrict payday loans as long as they present accurate information to their customers. These establishments are simply offering a service just like any other company, and it makes sense to let the market decide what the optimal interest rates should be. Nobody is forcing others to borrow from these lenders. Individuals make their own decisions as to whether or not they will borrow from these establishments. The government does not regulate the price of shoes, guitars, or haircuts, so why should they regulate the price of money? In this argument, the extent of government oversight should extend only to prosecuting fraud and making sure all contracts and obligations are met, and the Truth in Lending Act already fulfills that basic need.

There are many other arguments that payday lenders use to justify their existence, some more compelling and others a bit of a stretch. Of course, it is important to know who is making the argument, because these companies have a vested interest in highlighting any good and minimizing any bad the industry produces in order to stay in business. Like any argument, there is a lot of nuance, and those on both sides should be heard.

Drawbacks of Payday Lending

Having a negative view on payday lending is definitely the popular opinion presented in most of the literature on the subject. Many people see it as a moral issue, with disadvantaged people who cannot afford to pay their bills being exploited for financial gain. However, others see it in more of a practical sense. Take the following Adam Smith quote for example:

> The legal rate, it is to be observed, though it ought to be somewhat above, ought not to be much above the lowest market rate. If the legal rate of interest in Great Britain, for example, was fixed so high as eight or ten per cent, the greater part of

> the money which was to be lent would be lent to prodigals and projectors, who alone would be willing to give this high interest. Sober people, who will give for the use of money no more than a part of what they are likely to make by the use of it, would not venture into the competition. A great part of the capital of the country would thus be kept out of the hands which were most likely to make a profitable and advantageous use of it, and thrown into those which were most likely to waste and destroy it. Where the legal rate of interest, on the contrary, is fixed but a very little above the lowest market rate, sober people are universally preferred, as borrowers, to prodigals and projectors. The person who lends money gets nearly as much interest from the former as he dares to take from the latter, and his money is much safer in the hands of the one set of people than in those of the other. A great part of the capital of the country is thus thrown into the hands in which it is most likely to be employed with advantage.
> No law can reduce the common rate of interest below the lowest ordinary market rate at the time when that law is made. Notwithstanding the edict of 1766, by which the French king attempted to reduce the rate of interest from five to four per cent, money continued to be lent in France at five per cent, the law being evaded in several different ways (Smith, Adam).

Smith, of course, was not referencing the modern phenomenon of payday lending, however the principle still applies. According to the excerpt, he did not advocate for a laissez-faire capitalistic approach to deciding usury laws. Smith recognized that some sources of capital would seek to exploit high-risk individuals in order to make, ironically, quick cash. If the interest rates were legislated to be lower, lenders would be pickier to whom they lent money. However, if it becomes too low, loan-sharks will seek to capitalize on peoples' needs. This sentiment was evident in the Universal Small Loan Laws mentioned earlier. Smith makes a good point, but unproductive capital is not the only reason that so many have such disdain for payday lenders.

Many argue that payday loans are predatory in nature and seek to keep the borrower in a "debt trap." Whether or not this is the intent of the lender, it seems to align with the facts as a study by the Consumer Financial Protection Bureau found that "four out of five payday loans are rolled over or renewed within 14 days." This would seem to somewhat counteract the point presented by payday lending supporters that payday loans are a good alternative to overdraft fees or utility hookup fees. This point would make sense if a one-time payday loan fee was cheaper than the alternative late fees, but since they are generally rolled over, the argument loses credibility, even if the original intent of taking out the loan was financially sound. Additionally, the study found that "three out of five payday loans are made to borrowers whose fee expenses exceed amount borrowed." Payday lenders have figured out a way to siphon money out of the working poor's bank accounts.

Any profit that goes to a payday lending company is money being taken out of the United States' most vulnerable communities that could be put to better use under different circumstances. It could be argued that it is not as simple as a contract between borrower and lender, but instead these loans result in externalities that affect others outside of the original business agreement. This total wealth extraction added up to about $50 billion per year as of 2014 (Barth, James R.). Of course, not all of this would remain within the communities if payday lending was abolished, but it is very possible that a good portion of it would. The Consumer Financial Protection Bureau also found that 20 percent of borrowers will default on their loan at one point or another. This leads to a host of unpleasant outcomes including, "bank overdraft fees, constant collections calls, damage to your credit scores, a day in court and garnishment of your paycheck (Weston, Liz.)" These unpleasant outcomes were the whole reason for taking out the loan in the first place.

In 2006, Congress passed, and the Department of Defense implemented the Military Lending Act. This act made it illegal to loan money to any active service member or their immediate family at any annualized percentage rate over 36%. The act was implemented because, "These practices could pose risks for service members and their families and could pose a threat to military readiness and affect service member retention ("FDIC Consumer Compliance

Examination Manual.)" It can be extrapolated that if Congress considered high interest loans to be a threat to servicemembers, the loans would also be damaging to the population at large. The civilian sector is just as vulnerable to high interest rates as the military. The act also cemented into place what a federal ban could look like as opposed to the state laws currently on the books.

Another problem with payday lending is that it can lead to unnecessary consumption as people fail to recognize the severity of their financial situations. A study on liquor sales and payday lenders in the Pacific Northwest found a "persistent reduction in liquor sales resulting from payday lending regulations that restricted access for frequent payday loan users." Additionally, "for liquor stores located nearest to a payday lender, the effect of the law change is almost three times as large as that observed overall (Cuffe, Harold)." So, not only are payday lenders taking money directly out of poor neighborhoods, but also indirectly keeping people from making wise monetary choices to improve their financial health. If the borrowers were not lulled into a false sense of security, they would likely tighten their belts and only spend on the basic necessities until they had enough to get out of their financial crisis.

There has been found to be a negative relationship between financial literacy and payday lending (Kim, Kyoung Tae.) This suggests that there is a disparity between what the perceived benefit of taking out a loan from a payday lender entails versus the actual benefit, or lack thereof. Of course, correlation is not the same as causation, and people might be in the situation where payday lending is their only option because their financial illiteracy has ruined their credit and left them with no savings. Either way, additional financial education would most likely lower the amount of payday loans. Payday lenders are subject to the Truth in Lending Act as well as other laws and are supposed to make annual percentage rates known to their customers, but there is evidence to show that payday lenders often attempt to deceive their clientele. According to the Federal Trade Commission:

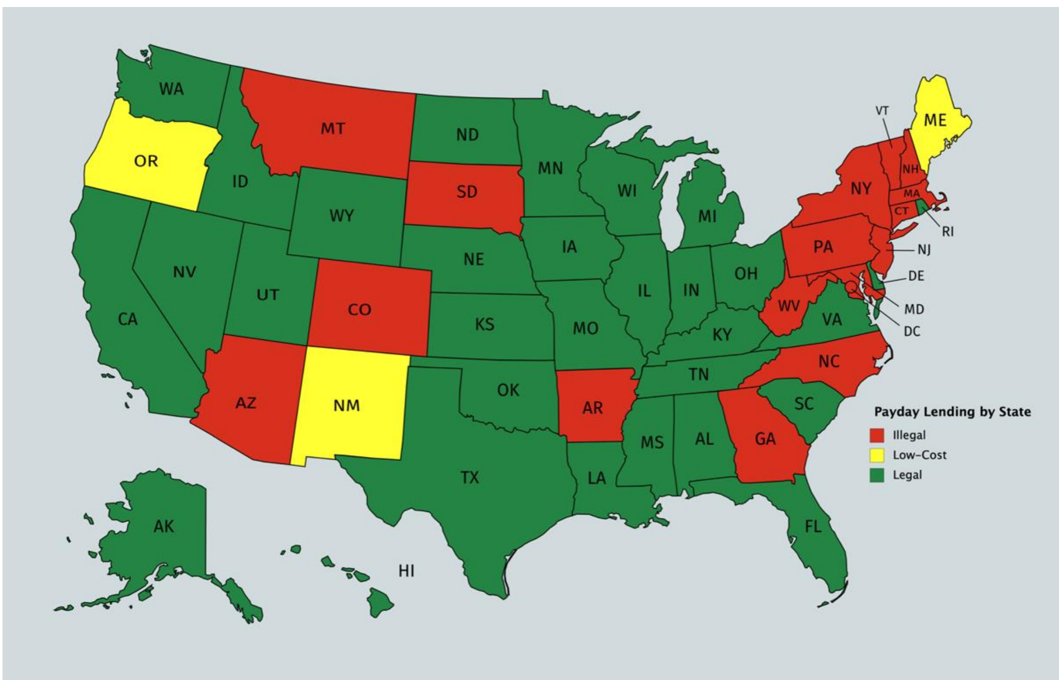
> The FTC enforces a variety of laws to protect consumers in this area. The agency has filed many law enforcement actions against payday lenders for, among other things, engaging in deceptive or unfair advertising and billing practices in violation of Section 5 of the FTC Act; failing to comply with the disclosure requirements of the Truth In Lending Act; violating the Credit Practices Rule's prohibition against wage assignment clauses in contracts; conditioning credit on the preauthorization of electronic fund transfers in violation of the Electronic Fund Transfer Act; and employing unfair, deceptive, and abusive debt collection practices. The FTC has also filed recent actions against scammers that contact consumers in an attempt to collect fake "phantom" payday loan debts that consumers do not owe. Further, the FTC has filed actions against companies that locate themselves on Native American reservations in an attempt to evade state and federal consumer protection laws.

It is difficult to justify keeping payday lenders legal in order to stop illegal lenders when, in many cases, payday lenders are the ones operating outside the law themselves.

Lastly, the lesser of two evils argument presented by proponents of payday lending is not true for everyone. If people did not have access to payday loans in an emergency, it does not necessarily mean that they will not be able to pay the bills. In many cases, individuals have some other resources on which he or she can fall back, but the quick and private nature of payday loans wins out over these resources. Whether it be pride, ignorance, or a lack of effort, some people prefer to go to a payday lender instead of taking the time to shop around and find a credit card, bank, or family member to help in an emergency situation. Legislation would force people to think differently.

<u>Current State of Legal Affairs</u>

Currently, sixteen states and Washington D.C. do not allow payday loans, three states allow "low-cost" payday loans, having special laws in order to protect borrowers, and thirty-one states fully allow payday loans ("Legal Status of Payday Loans by State.")



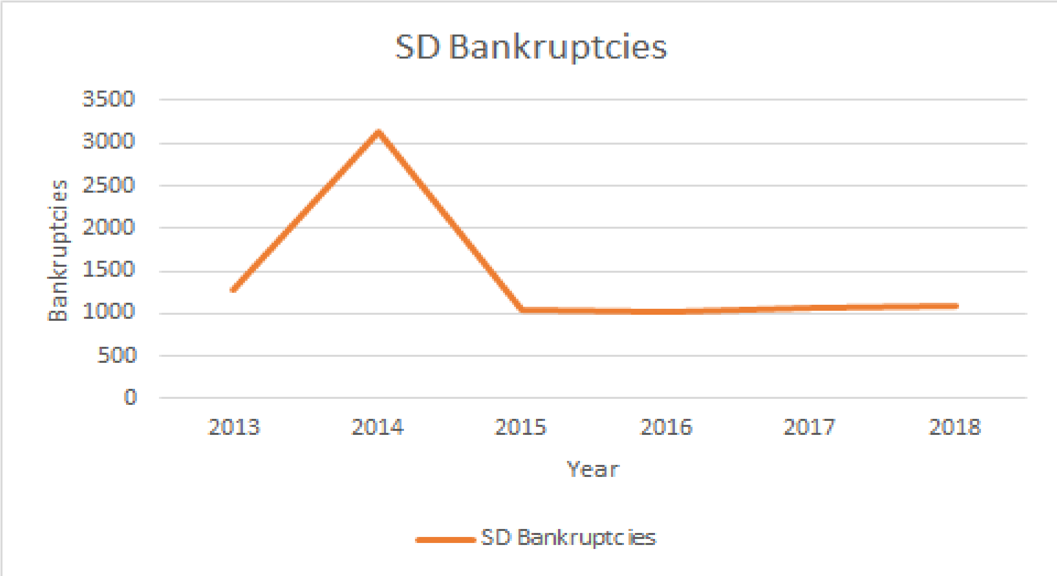
In addition to state usury laws, the Military lending act is on a national and caps the top yearly interest rate at 36% as mentioned earlier.

<u>My Findings, Do the numbers add up?</u>

The fact that states differ in their regulation of payday loans is good for analytical purposes. Each state provides valuable data for comparison, especially when they change the rules. One such state that has recently had a dramatic shift in its payday loan laws is South Dakota. The state used to have a thriving payday loan industry with annual percentage rates that could be as high as 574%. However, in late 2016, a landslide vote caped loans at 36%. While this did not explicitly ban the practice of payday lending, it was a deadly blow to the industry, and from a practical sense, the industry cannot function as it once did ("South Dakota Payday Loan Law and Legislation.")

Personal bankruptcy rates can be a direct indicator of the financial strain that payday lenders put on individuals. In order to test the effect that outlawing payday lending made on personal bankruptcy rates, it would be necessary to perform a difference in difference regression against the neighboring states which did not change their laws. We selected North Dakota, Minnesota, Iowa, Nebraska, Wyoming, and Montana, because these states would have the most similarities to South Dakota. Of these states, Montana is the only state in which payday lending is illegal, banning it in 2011.

The following chart shows the number of personal bankruptcy filings in South Dakota over time:



The initial information on bankruptcy rates was collected from the American Bankruptcy Institute. The information was promising, but it would be better to gather the data from its source. The American Bankruptcy Institute was contacted, and they pointed in the direction of the United States Courts website. The United States Courts website publishes F5-A forms, which give county level bankruptcy data on a quarterly basis. Since late 2016 is when payday loans are outlawed in South Dakota, data was collected for the period from 2013 to 2018. After downloading all of the forms, they were compiled into a single spreadsheet. The personal bankruptcy data was isolated from total bankruptcies because business bankruptcy data would not apply to this study.

In addition to payday lending, other demographic factors could account for a difference in bankruptcy rates and should be added to the model. County level data on poverty and median annual household income was obtained from the SAIPE datasets section of the United States Census website for 2013 through 2018. The two were available on the same spreadsheet, but divided into individual years. After downloading the datasets for each year and compiling them into another sheet of the same Excel workbook as the bankruptcy data, county level population data, and net immigration numbers were also collected from the U.S. Census website and given individual sheets of the workbook. Lastly the Bureau of Labor Statistics supplied the county level unemployment rates. These were eventually all compiled into separate sheets of an Excel workbook. Once this was complete, they were able to be compiled into R studio. From the data sets, data for the seven states was isolated and a dummy variable was created with the value of zero or one. If it had a one, there was a payday lending ban. If it had a zero, payday lending was legal. R-studio registered these with a true/false logical value. Once this was completed, the data was combined into a master table by FIPS code and year with the following headings, FIPS, Year, Poverty, Bankruptcies, Median Income, Population, Unemployment, Net Migration, Payday Lending Ban. Lastly, from the entire United States, the states needed for this study, North Dakota, Minnesota, Iowa, Nebraska, Wyoming, and Montana, were isolated into a new table so that they could be tested without being skewed as much by other states.

Some summary statistics from the selected states for the regression are as follows:

	Min.	1st Quartile	Median	Mean	3rd Quartile	Max	Standard Deviation	NA's
Poverty	3.5	9.6	11.4	12.48	13.7	56.7	5.44	0
Bankruptcies	0	5	15	77.19	47	8554	360.99	228
Median Income	21572	46927	51689	52778	57275	104248	9791.15	0
Population	451	4634	9926	28845	21687	1259428	80004.49	0
Unemployment	1.2	2.8	3.5	3.78	4.4	15.5	1.44	0
Net Migration	-2994	-66	-12	64.59	39	5769	468.39	0

	FALSE	TRUE
Payday Lending Ban	2394	468

It was important to control for unemployment with state and year fixed effects, because even though all of these states are similar, there are still economic factors that could skew the results without controlling for them. For example, "South Dakota's economy grew a robust 9.2 percent in the third quarter of 2015, by far the largest gain in the nation (Doering, Christopher.)" This growth was due to factors completely unrelated to payday lending but controlling for these effects should counteract those differences. Also, if there was a trend throughout all of the years happening in all states, such as recovery from a country-wide financial crisis, these fixed effects should control for that also.

From the compiled data, a regression was created and ran with the formula:

Bankruptcies = Poverty + Median Income + Population + Unemployment + Net Migration+ Payday lending ban * factor (Year), (With fixed effects for counties.)

Coefficients:							
	Estimate	Std. Error	t. Value	Pr(>|t|)	CI Lower	CI Upper	DF
Poverty	2.87E+00	2.34E+00	1.22615	0.22025	-1.72E+00	7.466002	2611
Median Income	2.15E-03	1.80E-03	1.19961	0.2304	-1.37E-03	0.005674	2611
Population	6.49E-05	2.78E-04	0.23336	0.8155	-4.80E-04	0.00061	2611
Unemployment	-2.14E+00	4.16E+00	-0.51329	0.60779	-1.03E+01	6.019911	2611
Net Migration	6.04E-02	4.30E-02	1.40384	0.16049	-2.40E-02	0.14474	2611

Payday lending ban TRUE	2.12E+01	2.12E+01	0.99878	0.31799	-2.04E+01	62.77057	2611
factor(year)2014	1.96E+01	2.53E+01	0.77218	0.44008	-3.01E+01	69.18854	2611
factor(year)2015	4.05E+01	2.61E+01	1.55266	0.12063	-1.07E+01	91.71606	2611
factor(year)2016	1.14E+01	2.23E+01	0.51264	0.60825	-3.23E+01	55.19187	2611
factor(year)2017	9.90E+00	2.49E+01	0.39742	0.69109	-3.89E+01	58.72169	2611
factor(year)2018	-3.11E+01	1.49E+01	-2.08699	0.03699	-6.02E+01	-1.87626	2611
paydaylendingbanTRUE:factor(year)2014	-2.55E+01	2.95E+01	-0.86629	0.38641	-8.33E+01	32.25985	2611
paydaylendingbanTRUE:factor(year)2015	-5.65E+01	2.94E+01	-1.92253	0.05465	-1.14E+02	1.127434	2611
paydaylendingbanTRUE:factor(year)2016	-2.44E+01	2.62E+01	-0.92999	0.35246	-7.58E+01	27.02289	2611
paydaylendingbanTRUE:factor(year)2017	-1.75E+01	2.79E+01	-0.62886	0.5295	-7.22E+01	37.12225	2611
paydaylendingbanTRUE:factor(year)2018	-6.36E-01	1.87E+01	-0.03412	0.97279	-3.72E+01	35.92438	2611

Results

Interestingly enough, banning of payday loans did not have a significant difference in bankruptcies for the years tested. With a P-value of .31799, banning payday lending is nowhere close to the value of .05 needed to overturn the null hypothesis that payday loan legality has no effect on bankruptcies.

Limitations and Potential for Future Work

While this project controlled for several factors, there is still much left on the table. One limitation for this project was the small sample size of states that have changed their payday loan laws over the years of available county-level data. It is possible that South Dakota is an outlier, but it is difficult to tell since it is the only state analyzed in this study. More analysis should be run to determine whether or not there is a consistent trend. Data for such an analysis would be easier to obtain at a state-level as opposed to a county level. Another limitation would be a lack of data concerning illegal activity. If more information were obtainable about unregulated loans, it would add to the study significantly. Also, there are variables that pertain to the use of payday lending that are more difficult to measure. This could be stress, family strain, perceived well-being, and other more subjective variables. If payday loan users were directly contacted and questioned, a substantial amount of valuable information could be gathered, but this would be very labor intensive.

While the data might indicate that payday lending legality does not have a meaningful effect on bankruptcy rates, there are some factors outside the model that can confound the data. One potential confounding factor is that there could be some carry-over of loans made before the ban was put in place. When payday lending stores closed after the ban was implemented and their license expired, they would call in their debts all at once, and this could confound the clean break from before and after the ban (Pfankuch, Bart.)

Potentially the most confounding variable are online payday lenders. While it is technically illegal to offer these services above the usury rate in South Dakota, the online companies are much more difficult to regulate (Pfankuch, Bart.) Whether the online lender be a foreign company, a Native American tribe, or other entity, they will attempt to claim they are legitimate and offer these loans. While they would not likely stand up in the court of law, many people either do not know this or do not have the means to risk fighting them (Heath, David.)

For a future project, county level data would be useful to determine if individuals living in a state where payday loans are illegal, but close to the border of a state where they are legal were more likely to file bankruptcy. This not only has the potential to correlate bankruptcy with payday loans, but also determine whether or not interstate payday loans are happening. It would also be interesting to see more studies on the use of online payday lenders to see how widespread their use is, especially after a ban on payday lending.

Conclusion

This study shows that the effects of payday loans are not as cut and dry as one would hope. While the data does not directly show that payday loans result in a higher level of bankruptcy, it does not disprove it due to the aforementioned limitations. Moving into the future, with more states deciding to regulate payday lending, it will be easier to definitively state whether or not payday loans increase bankruptcy rates from an analytical standpoint. However, the results of this study do not show a link between the two. Perhaps payday loans only extend the inevitable for some people in compromised financial situations, and others find other lines of credit that also terminate in bankruptcy.

Despite the ambiguous findings, some conclusions can be drawn from the literature and historical context. While payday loans have been shown to be problematic for a number of reasons, banning them is not a solution that fixes all the underlying problems. While payday lenders create a whole host of new dilemmas and burdens, they are a symptom of a greater issue plaguing poverty stricken neighborhoods. They only exist because there is a market for them, and to ban them does not get rid of the market. To rid society of the woes associated with payday lending, it is necessary to address poverty, a lack of affordable credit, and a lack of personal finance education head-on. While banning payday loans without setting up an alternative monetary framework and education system might cause some to become more resourceful and make better financial decisions, it is likely to drive others to act outside the law and create an entirely new host of unintended consequences that could be worse than bankruptcy. Whatever the solution is, it will not be simple, but it is definitely possible.

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Completion and approval of Honors capstone project

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Bill and David,

I approve Jordan Haney's final Honors Capstone project. I've attached my signed version.

Best regards,
Wafa Orman.

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