Economic Impacts of Payday Loans

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Payday loans are small, unsecured and short-term loans. They are high interest rate loans that are usually repaid on the borrowers' next payday. The average value of a typical two-week payday loan is around $387 in Florida. The average transaction fee is $38.50 and the average verification fee is about $3.05 in Florida (Veritec, 2012). The corresponding annual APR for a two-week payday loan of $387 and $41.55 fee is about 290 percent. Although payday loans have very high APR rates, few payday loan customers remember the APR on the most recent payday loan (Elliehausen, G., and E. C. Lawrence, 2001). To reduce APR on payday loans many states have moved to put a cap on payday loan fees. Recent surveys indicate that 42.3 percent of payday customers find it is easier and quicker to get payday loan than to qualify for a bank loan. 19.7 reported that banks do not make small dollar loans. Only 13 percent of the payday customers prefer the payday loan place because it is more convenient (FDIC report, 2012).

Payday lending advocates have argued that access to payday loans mitigates financial distress by allowing customers to pay for emergency needs. Recent studies have shown that, on the contrary, loan availability has led to more financial difficulty (Meltzer, 2011). Among the low –to-moderate-income families access to payday loans increased the incidence of difficulty paying bills by 25%. For adults in these families, access to payday loans increases the delay of needed medical care, dental care and prescription drug purchases by about 25% (Meltzer, 2011). Instead of mitigating financial distress, payday loans tend to actually increase financial difficulty for their borrowers. Payday lenders drain resources from communities without providing a meaningful service in return.

Payday loans as excessive taxes on communities

A recent national survey (Applied Research and Consulting, 2009) found that 5 percent of respondents said they used payday loan in the past five years. Most of the payday customers are low-to-moderate income households with income range of $15,000-$50,000. In Florida an average payday lending customer receives payday loan nine times in a year (Veritec, 2012). Payday lending stores make most of their profits from frequent borrowers because they receive higher return from the frequent borrowers. About 72 of payday loan customers borrowed from only one store in Florida in 2012 (Veritec, 2012).

The profit maximizing model of payday lending is based on lending to frequent borrowers and therefore finding new frequent borrowers. When a customer borrows multiple times from the same store, he/she contributes to the store's profit in two ways: First when the store serves the same customer multiple times it saves on paperwork and search costs. Second, the frequent borrowers have lower rate of default. This model enables the payday lenders to extract the maximum amount of profit from the borrowers. Since the store owners and their employees are less likely to reside in the local community, a portion of the neighborhood disposable income in terms of loan fees is transferred out of the neighborhood. This transfer works like a tax on disposable income for payday loan borrowers. The following example shows the actual impact.

Average payday store executed 365 transactions per month in Florida in 2012. The average amount of the loan was $387 and the average amount of transaction fees including verification fees was $41.55. The average store collected total transaction fees of $14,046 per month. On

annual basis, an average store collected about $168,552 in terms of total transaction fees (Veritec, 2012). In a small community with two payday lenders, (168,552*2 =337,104) about $337,104 would be drained out of the community. In a way, payday lending works like a tax without any service in return for the community. Payday loans also work as excessive tax on household wealth. A typical payday loan customer who pays about $600 per year for short-term payday loans is also losing $600 worth of saving every year. If this money is invested in a diversified portfolio over 30 years, it would create a wealth of $75,000 (Fellowes and Mabanta, 2008).

As mentioned before, access to payday loans increases the financial difficulty for borrower and it does not mitigates their financial distress as claimed by the advocates of the payday lending industry. The likelihood of experiencing a financial difficulty will increase by 25 percent for a payday loan borrower. This will have a negative effect on personal health and wealth. When a medical treatment is postponed because of financial difficulty, it may turn into adverse long-term health problem. When a mortgage payment is delayed or car payment is not made on time, the individual will be in danger of losing his house or car. Although it is hard to directly quantify the economic impacts of the increase in financial difficulty caused by easy access to payday loans, it is clear that the likelihood of bankruptcy is increased not decreased by easy access to payday lending.

Since most of the customers of the payday loans are also those with lower level of economic security, a significant share of these customers will be pushed into poverty. Thus payday loans are expected to increase the share of below poverty population. Additionally as payday loan fees

function as a tax on the local areas disposable income it depresses economic activity, and reduces the level of saving in the area. When the local disposable income base is reduced by payday loan fees, it will reduce the purchasing power in the area and as a result reduces the demand for local businesses and services. This negative effect on income and jobs will take place through usual multiplier process. The decrease in local disposable income reduces the level of savings which will reduce the level of future wealth creation.

The payday industry advocates argue that the increase in the number of stores will benefit the consumers because stores compete by lowering their payday fees. The empirical studies did not find evidence to support this claim. Maximum payday advance fees are set by regulations in most states. The recent studies have found that payday stores tend to charge effective APR close to the maximum amounts set by the states. Apparently more competition as defined by increase in the number of store fronts has not reduced payday fees. Therefore, without effective state cap on loan amount and fees, payday lenders will continue to charge very high APR and transfer a significant portion of disposable from lower income population to higher income population in the states where payday lenders face very limited regulation.

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