

New Evidence on Payday Lending

This spring, [Illinois](#) became the [18th state](#) to ban high-interest payday loans. On the same day, the Consumer Financial Protection Bureau [announced](#) its intention to return to “vigorous” payday loan regulation, citing “real harm to real people.”

Does this regulation actually improve people’s lives?

Payday loans are small (usually [\\$250 to \\$500](#)) loans that must be repaid on the borrower’s next payday, with typical interest of \$15 per \$100 borrowed. About 10 million Americans get a payday loan in a normal year.

Consumer protection advocates such as Senator Elizabeth Warren [argue](#) that payday loans “trap” borrowers in a “cycle of debt that crushes families and sucks money out of communities that can least afford it.” Half of payday loans are part of sequences at least [10 loans long](#), and a sequence of 10 \$400 loans would typically involve \$600 in interest. That’s a lot of money, especially for an average borrower earning about [\\$30,000](#) per year.

Payday loan advocates argue that restricting payday loans [takes away credit](#) at the [exact moments when people need it most](#). Most borrowers have [maxed out their credit cards](#) and exhausted other opportunities for cheaper loans, so payday loans might be the only way to fix the car or pay rent on time.

But neither of these arguments directly answers the key question: are borrowers acting in their own best interest? This spring, we released a [peer-reviewed study](#) that directly tests two leading theories of borrower mistakes.

Overoptimism

The first theory is that payday loans are deceptive. It’s not that people misunderstand the loan terms – indeed, borrowers say they really like the [simplicity and transparency of payday loans](#). Instead, the theory is that people underestimate how long it will take to pay back, and this overoptimism makes them too eager to borrow. This theory plays a key role in Senator Warren’s advocacy for payday lending regulation: “A customer who misestimates her ability to repay the loan in fourteen days will likely roll the loan over for another fourteen days,” she wrote in an important [2008 article](#) advocating for the establishment of the CFPB. “The payday loan product is arguably designed to take advantage of consumers’ optimism bias and their consistent underestimation of the risk of nonpayment.”

Our data partially support this theory. Inexperienced borrowers are overoptimistic: they think they have a 60 percent probability of getting another loan in the next eight weeks, whereas 78 percent of them actually do. However, the overoptimism disappears with experience. By the time the average person has gotten a few loans, they're fully aware that they're likely to keep borrowing.

Bias toward the present

The second theory of borrower mistakes is that payday loans facilitate humans' natural tendency to spend too much in the present at the expense of our future. Just as the social security system makes us tighten our belts and save so we're not broke when we retire, perhaps banning payday loans makes us tighten our belts and avoid debt so we're not broke next month.

Our data strongly support this theory. About 90 percent of borrowers we surveyed said they want extra motivation to avoid payday loan debt in the future. To quantify this desire for motivation, we offered borrowers a \$100 incentive if they avoided payday loans for the next eight weeks. Most borrowers reported that this incentive would indeed help motivate them to stay out of debt. The average borrower preferred to receive the motivational \$100 incentive over a certain payment that would earn more money on average, implying that they were willing to give up money in exchange for motivation to avoid payday loans.

Policy implications

Do the costs of mistakes outweigh the benefits of credit access?

Although benefit-cost analysis is the gold standard of policy evaluation, it is challenging for payday lending because it's difficult to quantify the dollar costs of borrower mistakes. Our study provides a new approach.

Our analysis requires many assumptions, so it's only a first step. But in our analysis, the only way to justify a ban on payday loans would be if consumers were *persistently* overoptimistic. With persistent overoptimism, people would repeatedly borrow while expecting to get out of debt *next* month, and payday loan access does more harm than good. But remember, that's not what our data show: the overoptimism disappears after a few loans.

In our analysis, a more promising regulation is a middle ground approach: a required 30-day "cooling-off period" after three consecutive loans, similar to the one the CFPB issued in 2017 and rescinded in 2020. This still allows people to borrow for short-term crises but forces them to pay back the debt quicker. In essence, this provides the motivation that people in our study say they want.

Many states have repeat borrowing limits, but the cooling-off periods are often less than a week. This [limits their effectiveness](#), because borrowers usually won't run short of cash until closer to the end of their two-week or four-week pay period.

Although our analysis isn't structured to evaluate other policies, other evidence suggests that moderately tighter interest rate caps that still allow lenders to operate (as in [Rhode Island](#)), shifts to installment loans that encourage people to gradually pay back (as in [Ohio](#) and [Virginia](#) and the CFPB's now-rescinded 2017 rule), and encouragement of lower-cost alternatives (such as [Deposit Advance Products](#) and [other short-term](#) loans offered by banks and fin-tech companies) might benefit consumers.

While our analysis suggests that banning payday lending wouldn't help borrowers on net, this does not mean that all is well and good. We should try to build a society where people do not have to rely on high-cost loans to make ends meet. More direct empirical evidence and careful benefit-cost analysis can help us get there.

[Hunt Allcott](#) is an economist at Microsoft Research and a visiting instructor of economics at MIT. [Joshua J. Kim](#) is a research scientist at Facebook. [Dmitry Taubinsky](#) and [Jonathan Zinman](#) are economics professors at Berkeley and Dartmouth, respectively.