
Are Usurious? Another New Argument For the Prohibition of High Interest Loans?

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A COMMENT ON Robert Mayer (2012), “When and Why Usury Should be Prohibited,” *J Bus Ethics* OnlineFirst (September), <http://dx.doi.org/10.1007/s10551-012-1483-3>

ABSTRACT

Robert Mayer argues that certain kinds of high-interest payday loans should be legally prohibited. His reasoning is that such lending practices compel more solvent borrowers to cross-subsidize less solvent ones, and thus involve a kind of negative externality. But even if such cross-subsidization exists, I argue, this does not necessarily provide a ground for legal prohibition. Such behavior might be a necessary component of a competitive market that provides opportunities for mutually beneficial transactions to willing customers. And the alternative of a government-mandated interest rate faces severe problems of its own.

ARGUMENTS AGAINST USURY are almost as old as philosophy itself. For the most part, however, these arguments have fallen into serious disrepute. Few if any contemporary ethicists believe that there is anything immoral about the charging of interest *per se*. And thanks largely to the final triumph of subjectivist theories of economic value over labor and cost-of-production theories in the 19th century, lending it-

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self is now widely and rightly regarded as an economically productive activity, rather than as a cloaked form of theft.

But while usury in the broad sense of lending at some interest is now generally regarded as a moral non-issue, usury in the narrower sense of lending at very high interest is another matter. Many, perhaps most, contemporary ethicists regard the latter as at least potentially morally wrong, especially when it involves taking unfair advantage of a person in a vulnerable situation. In such cases, usury might be thought to be a species of exploitation (Wertheimer and Zwolinski 2012). Even granting its immorality, however, many ethicists will be reluctant to advocate its legal suppression. For even if usury is a form of exploitation, it is usually a form of *mutually beneficial* exploitation (Zwolinski 2007, 2008). Both parties benefit from the exchange, even if one party benefits less than fairness requires. Suppressing mutually beneficial exploitation prevents unfairness, to be sure, but it also often makes both parties worse off than they otherwise would have been, and this often has a disproportionately harmful effect on the most vulnerable party.

Robert Mayer's (2012) "When and Why Should Usury Be Prohibited" presents a novel, philosophically and economically sophisticated argument for the prohibition of a certain kind of usury. It is a notably circumscribed argument—focused only on the kind of high-interest lending that occurs in the payday lending industry, and conceding that the arguments that count in favor of prohibition in that market probably do not apply in other contexts such as commercial lending (2012: 2). And even within that narrow context, Mayer argues for only a limited sort of prohibition—a cap on fees set at \$15 for every \$100 borrowed, or an effective Annual Percentage Rate (APR) of 391% for a 2-week loan. This might sound like not much of a cap at all, but bear in mind that in unregulated markets, fees can reach an equivalent of 782% APR (2012: 3).

Mayer's argument for this claim is unusual in that it is based not on paternalism or concerns about exploitation as such, but on a certain kind of negative externality. According to Mayer, the structure of the payday lending market is such that the more solvent borrowers are compelled to cross-subsidize the less-solvent ones. The more solvent borrowers, he claims, could be serviced profitably at a fee of \$15, but

lenders earn even more profit by extending loans to the more- and less-solvent borrowers alike, and charging everybody a higher fee of, say, \$22 (Mayer 2012: 7). Because their demand for quick cash is relatively price-inelastic, the more solvent borrowers tolerate this situation which, in Mayer's (2012: 2) words, amounts to "a sort of conspiracy between the top and the bottom against the middle."

On Mayer's account, then, greedy lenders are taking advantage of vulnerable borrowers who need cash quick and lack the information and the time to shop around effectively. But stories like this should make us suspicious. If charging high prices to vulnerable borrowers is such an easy way to make unusually large amounts of money, then wouldn't we expect many more people to go into this line of work? And as more people go into it, wouldn't we expect the added competition to drive prices down to something close to the cost of providing the loan? On the other hand, if on closer examination we find that lenders are *not* reaping unusually large profits – if their profits are what we would expect to find in just about any normal industry – then shouldn't this lead us to question the assumption that the prices they are charging are really unfair?

In fact, payday lending operations are not especially profitable. One study, for example, found that payday lenders earn an average profit margin of just 7.63%. By way of comparison, the study notes that the average rate of profit at a Starbucks store is 9%. And when only "pure" payday lenders are considered – those that do not derive additional revenue from, say, co-located pawn shop operations – the average rate of profit drops to 3.57%, or less than half the average rate of profit at Starbucks (Huckstep 2007: 227).

So, if cross-subsidization increases lenders' profits, but profits even after cross-subsidization are no higher than normal market levels, then perhaps cross-subsidization is necessary for payday lending – even to the more solvent customers alone – to be profitable at all. But if cross-subsidization isn't lining lenders' pockets, but is instead necessary strategy just to earn a normal profit, can engaging in it really be unfair? And if it is not unfair, is it really appropriate to use the coercive power of the law to suppress it?

Mayer is probably aware of concerns like this. But Mayer is convinced by the evidence he surveys that payday lending markets are not, in fact, competitive ones where price is determined by marginal cost. The empirical data on which Mayer's argument rests show that most lenders in a given market charge essentially the same fees for their loans, and that those fees are almost always the same for all customers, regardless of their credit-worthiness. It also says that customers of payday lenders cite convenience, over price, as the determining factor in where they obtain their loan. From this evidence, Mayer concludes that demand for payday loans is price-inelastic.

But price inelasticity of demand is not the only possible explanation for the data that Mayer cites. Another possible explanation is that payday lending markets are, in fact, competitive. This would explain why prices converge in a given market. And the fact that most customers do not consciously shop around on the basis of price gives us little reason to doubt the competitiveness of the market as a whole. Market competition can push prices toward the equilibrium even if many or most consumers do not base their purchasing decisions primarily on considerations of price. I never comparison shop toothbrushes, but I suspect that the average price of toothbrushes is somewhere close to the equilibrium price. Indeed, if prices are uniform in a given market (whether because they equal the competitive equilibrium price or not), we would expect most customers not to cite price as a major factor in their decision regarding where to obtain the loan.

In addition to price inelasticity of demand, Mayer (2012: 8) cites the lack of easy availability of information about lenders' fees as another reason for doubting the competitiveness of payday lending markets, noting that most lenders refuse to disclose their rates over the telephone. But Mayer seems to dramatically overstate the difficulty in obtaining information about lender's rates. As a small experiment, I ran a search on Google for "payday loans," and clicked on the first site that came up: CheckIntoCash.com. Within about ten seconds, I had found a detailed chart listing fees and equivalent APRs for their online loans (about \$17.65 per \$100 borrowed, or 460% APR). Thinking that perhaps the local market might be less forthcoming than the national internet market, I searched for "payday loans San Diego." Again, the first site that came up (CheckNGo.com) presented the fees charged at its local stores quite clearly (this time \$17.64 per \$100

borrowed, or 459% APR). Admittedly, this doesn't amount to much of a scientific study. But nothing I discovered in my personal research appeared incompatible with a healthy, competitive lending market in which consumers have all the information they need to shop around by price, should they so desire.

Competitive markets might thus explain why prices are uniform in a given market. But why would lenders charge the same fees to all customers, regardless of their credit-worthiness? Wouldn't it make sense to charge the riskier customers more, and the more solvent customers less? And isn't the fact that lenders *don't* do this further evidence that customers' demand is relatively price inelastic?

But acquiring and analyzing information about customers' credit-worthiness is costly. And lenders will only pay that cost if they expect to earn it back in the form of increased profits through better lending decisions. If the costs of the information are sufficiently high, or its marginal utility sufficiently low, the lenders will not collect it even if their customers' demand is highly price elastic. Even in a perfectly competitive market, some information will simply not be worth collecting.

All told, then, the data cited by Mayer provides little compelling reason to conclude that payday lending markets are grossly noncompetitive. Even if they were, though, the question would remain: can government regulation do better? Mayer (2012: 5) is confident that sophisticated empirical analysis of existing payday lending markets can yield a "scientific rate of interest," a term he explicitly draws from the halcyon days of progressivism in the early 20th century. But interest is simply the price of money, and neither history nor economic theory give us much reason for confidence in the ability of central planners to set prices in a way that accurately reflects the radically dispersed "knowledge of the particular circumstances of time and place" in the way that market prices do (Hayek 1945: 521). Can scientific analysis really reveal to us a price that is appropriate for all times and circumstances, and that can serve to exclude all and only those borrowers who would otherwise impose a negative externality on others? Is there any more reason for us to believe that central planners can determine the "correct" price of money than there is to believe that they can determine the correct price of automobiles or grain? And even if they *could* do it, is there any reason for us to be-

lieve that they *would* determine interest rates in a way that was genuinely responsive to considerations of the public good, rather than those of vested and powerful private interests?

Mayer's foil in this article is an article by Alyssa Labat and Walter Block (2011), two hard-line libertarians who hold that any loan that is voluntarily agreed to by both parties is necessarily fair. But one needn't take such an extreme view to think that prohibitions on usury – even those of the relatively modest sort advocated by Mayer – are a bad idea. Nor need one think, as Mayer (2012: 2) suggests, that the interests of the least well-off have an absolute lexical priority over all other moral considerations. It is enough to note that payday lending is a voluntary, mutually beneficial inter-action; that it is one that is sufficiently constrained by competitive pressures to ensure that no party is in a position to take unfair advantage of the other; and that the ability of regulatory bodies to improve on market outcomes is sharply constrained by lack of both proper incentives and sufficient knowledge.

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