

Study by Yale and Dartmouth Economists Finds High-Risk Borrowers Benefit From High-Rate Loans: Borrowers see wide-ranging long-term benefits

A July 2007 study, “*Expanding Credit Access: Using Randomized Supply Decisions to Estimate the Impacts*,” by Dean Karlan, Yale University, and Jonathan Zinman, Dartmouth College, concludes that consumer lending benefits borrowers. Individuals taking high interest loans were less likely to be in poverty, less likely to be hungry or malnourished and less likely to have lost their jobs.

The study assessed the impact of high-risk loans on consumers by expanding high interest credit to rejected applicants in South Africa. The lender used in the study shared many characteristics with the American payday loan industry by offering small, high-interest, short-term, cash loans to the public.

Six to twelve months after taking the loan, borrowers experienced a wide range of beneficial outcomes. For example one-fifth spent money on their transportation which, among other things, allowed them to get to work and keep their jobs. Benefits such as these were long-term, indicating they were not the result of a “cycle of debt.”

Dean Karlan is an assistant professor of economics at Yale University and President of Innovations for Poverty Action. Jonathan Zinman is an assistant professor of economics at Dartmouth College and a Research Associate of Innovations for Poverty Action.

Read the full study at

http://www.dartmouth.edu/~jzinman/Papers/Karlan&Zinman_ExpandingCreditAccess_oct08.pdf

Noted in the report:

Policies restricting access to credit are misguided

“The default policy prescription in South Africa and much of the rest of the world (including parts of the U.S.) is to restrict access [to high-risk, high-interest credit] based on the presumption that vulnerable consumers overborrow in these markets. Our evidence casts doubt on this presumption and suggests that revealed preference carries the day: our consumers who borrowed at 200% benefited from doing so, at least relative to their outside options.”

“ The effects on credit scores [i.e. the increased likelihood of having a credit score] cast[s] doubt on the hypothesis that positive... effects [of the loan] will turn negative over longer horizons due to debt traps or other delayed realizations of the cost of borrowing.”

Expansion of high interest credit is beneficial

“Most importantly, [the study did]... not find any evidence that the net effects of expanded access to expensive consumer credit are negative.”

“...loans produced significant benefits for borrowers across a wide range [of] economic and well-being outcomes.... The results suggest that consumer credit expansions can be welfare-improving.”

“... expanded access to credit significantly improved... [borrowers’ lives]. Over the 6 to 12 month horizon, [borrowers]... were significantly more likely to retain their job... and [their]... incomes were significantly higher. [Families which borrowed]... were also less likely to experience hunger, and had more positive outlooks on their prospects and position. [There was no]... negative impact on... mental health (depression and stress).”

“In all, we do not find any evidence that expanding access to consumer credit reduces creditworthiness over a 2-year horizon. If anything the treatment seems to have had a (socially) beneficial impact on creditworthiness by increasing the probability of obtaining a credit score.”

“...on net the impacts [of these high interest-high risk loans] are significant and positive. We do not find any evidence that the positive 6 to 12 month impacts are transitory and driven by borrowers who have yet to realize the full costs of borrowing.”

Borrowers wisely use loans

“...the most common purpose for household borrowing is paying off other debt. This suggests that [loans] may be used to economize on interest expenses, and to maintain access to other credit sources by permitting timely repayment.”

“...the [second] most common purpose for household borrowing is transportation expenses (19.4%); this and the clothing category are consistent with work-related investments. Indeed we find large... effects on employment: [borrowers]... were... 13% more likely to be working at the time of the survey. Since everyone [given a loan] had verified employment at the time they entered the experiment, it appears that the treatment effect operates by enabling households to maintain employment by smoothing or avoiding shocks that prevent them from getting to work.”