

JOURNAL OF LAW, ECONOMICS & POLICY

VOLUME 11

FALL 2015

NUMBER 3

EDITORIAL BOARD 2015-2016

Manmeet Dhindsa
Editor-in-Chief

Jesse Hong
Executive Editor

Justin Hillman
Publications Editor

Gwen Ball
Managing Editor

Samantha Grunberg
Senior Articles Editor

Geoff Moody
Senior Notes Editor

Elizabeth Dalton
Matthew Devendorf
Senior Research Editors

Zeynep Elif Aksoy
Articles Selection Editor

Christopher Harris
Symposium Editor

MEMBERS

James Beaty

CANDIDATE MEMBERS

Blake Browning
Allison Curry
Erin Gallagher
Anshika Mehrotra
Easton Saltsman

Abby Chestnut
Lindsey Edwards
Erastosthenis D. Hasandras
Christian Nee
David Showalter
Peter Zuk

Colleen Conners
Dodd Fuller
Gina Lee
Doan Phan
Kyle Spencer

BOARD OF ADVISORS

Lisa E. Bernstein
Judge Guido Calabresi
Robert D. Cooter
Richard A. Epstein
Mark F. Grady
Bruce H. Kobayashi
A. Douglas Melamed
Eric Posner
Roberta Romano
Steven M. Shayell
Vernon L. Smith
Thomas S. Ulen

Henry N. Butler
Lloyd R. Cohen
Robert C. Ellickson
Judge Douglas H. Ginsburg
Michael S. Greve
Francesco Parisi
Judge Richard A. Posner
Hans-Bernd Schafer
Henry E. Smith
Gordon Tullock
W. Kip Viscusi
Todd J. Zywicki

JOURNAL OF LAW, ECONOMICS & POLICY

VOLUME 11

FALL 2015

NUMBER 3

CONTENTS

ELEVENTH ANNUAL SYMPOSIUM: CONSUMER CREDIT AND THE AMERICAN ECONOMY

ARTICLES

- 279 FOREWORD: CONSUMER CREDIT AND THE AMERICAN ECONOMY: AN OVERVIEW
Thomas A. Durkin, Gregory Elliehausen, and Todd J. Zywicki
- 303 ARE BIGGER COMPANIES BETTER FOR LOW-INCOME BORROWERS?: EVIDENCE FROM PAYDAY AND
TITLE LOAN ADVERTISEMENTS
Jim Hawkins
- 329 THE SOCIAL COSTS OF CREDIT REPORTING ERRORS
Richard Hynes
- 349 BEHAVIORAL ECONOMICS AND CREDIT REGULATION
J. Howard Beales III
- 367 DIFFERENCES IN CONSUMER CREDIT CHOICES MADE BY BANKED AND UNBANKED MISSISSIPPIANS
Thomas W. Miller, Jr.
- 413 RATIONAL CONSUMER IGNORANCE: WHEN AND WHY CONSUMERS SHOULD AGREE TO FORM
CONTRACTS WITHOUT EVEN READING THEM
G. Marcus Cole
- 463 NOVEMBER 14, 2014, JLEP SYMPOSIUM COMMENTS ON CONSUMER CREDIT AND THE AMERICAN
ECONOMY
Anthony Yezer

CONSUMER CREDIT AND THE AMERICAN ECONOMY: AN OVERVIEW

*Thomas A. Durkin, Gregory Elliehausen, and Todd J. Zywicki**

INTRODUCTION

It seems that few collections of related goods or services have historically evoked as much angst and commentary, or produced as much intellectual baggage, as use of personal, non-housing-related credit known today as consumer credit. Economists, behavioral scientists, historians, sociologists, teachers, lawyers, judges, journalists, and others through history have all offered their commentaries. Even theologians, and, naturally, politicians have weighed in on personal credit use since at least ancient Babylonian and Biblical times.

In our new book, *Consumer Credit and the American Economy*, we address the economic analysis of consumer credit as it has developed over the past century in the United States, exploring not only the economics of consumer credit but also the intellectual history of the study of consumer credit and its regulation. By looking back to historical sources we can better understand current debates over public policy regarding consumer credit and the historical forces that brought us to where we are today.

This special issue of the *Journal of Law, Economics & Policy* is dedicated to a symposium on our book and includes several papers by economists and legal scholars that takes our book as their point of departure. The purpose of the symposium, and the conference from which the papers are drawn, was not to simply collect reviews of the book but to treat *Consumer Credit and the American Economy* as a research agenda, to analyze the theories, hypotheses, and insights proposed in the book with an eye toward prompting further investigation in the field. The purpose of this introductory essay is to provide an overview of several of the book's key themes and claims, so that the interested reader who has not read the book will have an adequate backdrop for understanding the context in which the contributing authors provided their respective papers.

What is it about personal credit that has provoked so much commentary (and regulation)? It seems the answer is twofold: first, there is the view that credit use somehow involves an attempt to live beyond one's means, consid-

* Respectively, Senior Economist (Retired) and Senior Economist, Board of Governors of the Federal Reserve System, and George Mason Foundation Professor of Law, George Mason University Law School. The views expressed here are those of the authors alone and not those of the Federal Reserve Board or its staff. This essay is based upon parts of *Consumer Credit and the American Economy*, published in 2014 by Oxford University Press (also with Michael E. Staten). Because this article serves as a summary of the book itself, we have not provided citation information to our sources, all of which may be found in the book.

ered a moral evil in earlier centuries and potentially a cause of economic dislocations in more secular modern times; second, certainly also an ancient concern but one given new life in the US since World War II, is the accompanying view that personal credit simply has grown without bound until the country today is awash in a flood of personal debt.

As it turns out, supporting evidence for both of these views is weak. During the scientific revolution, new thinking produced the end of widespread belief in geocentrism and other old ideas, even witchcraft, as explanations for observed natural phenomena. But it seems that mythology about personal credit use as a social phenomenon lives on. In every generation it is reinvented into new rationales for the need of additional government controls. Certainly in modern times the use of consumer credit is widespread. Evidence shows that three-fifths to two-thirds of families have such credit outstanding at any one time in recent decades and that most consumers use consumer credit at least sometime during their financial lifetime. But this does not prove convincingly that consumer credit users either are misguided and somehow trying to live beyond their capacities or that resulting credit use is economically excessive.

I. CONSUMERS AND THEIR CREDIT

At its first level, the claim that credit permits living beyond one's means simply is visibly wrong on its face. For a consumer, borrowing resources now and paying them back later does not increase the total available for personal spending over his or her lifetime, unless the lender does not want to be paid back later. Lenders typically *do* want to be repaid, however, unless they are inherently charitable enterprises. Most lenders are not charities.

This means that lending and borrowing does not change the amount of the consumer's resources, but only the timing of their employment in personal spending. People borrow and then spend more today but repay and spend less later. To be sure, both borrowers and lenders can miscalculate what future prospects of a loan will be. Variability in future employment and income opportunities among borrowers promises that some loans are not repaid, a manifestation of the concept of risk. But risk does not change the amount of the resources involved, only the probabilities of which party ultimately ends up with them: the borrower retains them (or the benefits from them) if they are not repaid and, most commonly, the lender gets them back over time if they are.

The importance of the borrowing/lending process for consumers is not that it adds resources but that it can increase the total *benefits* of spending for borrowers by providing an opportunity to make relatively large expenditures now that provide benefits over time and produce a positive return over cost. Clearly many uses of credit imply such positive outcomes. Credit allows purchase of durable assets like vehicles, education, and others out of the succession of current paychecks, rather than using current income only on current

necessities plus the more mundane uses that are always available as alternatives (sometimes even referred to as “frittering away” the money).

Evidence shows that most consumer credit is used to acquire consumer-oriented assets that provide their return not in the moment when they are purchased or soon afterward, but rather over a longer period. For instance, cars and light trucks can provide access to better employment choices and the opportunity to live in a preferred location, providing valuable services to the purchasers for a lengthy period. Higher education provides more remunerative and satisfying employment opportunities possibly over decades. Likewise, home repairs and modernization protect and improve investments in housing assets, and household appliances and related durable goods, including furniture, carpeting, and fixtures, all provide services over a sometimes lengthy life but often do not fit within a weekly or monthly budget. Some durable goods like vehicles and boats are even usefully available as collateral, and lenders can then lend upon them as secured credit at lower risk and production cost per loan dollar, saving the buyer money and enhancing the net return on the items purchased.

Most purchases otherwise made on credit could be accomplished by accumulating cash first and then buying the item later, but this often is not the time pattern consumers prefer. For many goods, accumulating cash first could mean doing without the item or paying for more expensive substitute services for a period that might amount to years, both of which are costly. People could walk to work, for example, or they could ride bicycles or take the subway and bus rather than making payments on car loans. They could forego the pleasures of easily visiting friends and family by car as part of the costs they would bear. They also could use laundromats, and scrimp on other appliances and furniture or acquire used equipment. They could put on sweaters and coats if the furnace failed while saving to replace it, or they could live with relatives. Many people do all of these things in lots of places, but with limited length of lifetimes that often involve children in relatively early years of a family’s life cycle, waiting to make these investments is frequently not the preferred option in middle class societies if there is an alternative. The types of credit we observe in the marketplace in large part come about because they are the least costly ways of providing an acceptable alternative.

Thus, using credit to purchase productive assets does not imply living beyond one’s means; rather it implies the opportunity to change the timing of purchases to a better one. The alternative is to save and accumulate cash in advance of a purchase, but this is not necessarily the best plan. Alternatives in the meantime (public transportation, furnished dwelling rental, foregoing higher education, etc.) can be expensive to those who take those paths, often requiring replacements or foregoing purchase for a long time. Replacement services like public transportation may even be unavailable in many areas, precluding preferred employment and living choices. Postponing some home repairs, like a needed new roof or a furnace purchase, while accumulating nec-

essary cash in advance through monthly saving can even prove to be disastrous.

In effect, the motivation underlying borrowing by consumers is no different than it is for businesses contemplating new factories or shopping malls: a return on the assets financed. Although consumers may not specifically undertake the detailed risk-adjusted net present value calculus of the corporate financial analyst, consumers will consider the possibilities and will employ credit for purchases of automobiles, educations, home repairs, appliances, and large hobby items when their risk-adjusted rewards exceed their costs. The Federal Reserve Board's statistical efforts and analyses, including its periodic Surveys of Consumer Finances, show that most consumer credit is generated under the circumstances of financing the purchase of large purchases that provide their return over time.

To obtain this change in spending timing, borrowers pay interest, known in Truth in Lending requirements as a "finance charge." The finance charge serves as the needed inducement for the lender to defer its own current use of the resources elsewhere in some other way. The lending process amounts to the reverse of the timing change for the borrower, with the lender spending less now on its own uses in order to spend more later. But the possibility of a timing change and the accompanying exchange of a fee to bring it about has, literally, posed questions for millennia. As indicated, the implied behavior to be avoided by borrowers was for thousands of years the immorality of trying to live beyond one's means. Borrowing and lending should come about only in cases of true "needs." Attempting to restrict lending and borrowing to such situations leads immediately to the Biblical and medieval Church's prohibition on the taking of interest (usury) as an affront to the religious requirement for charity in such situations.

More modern economic analysis in the twentieth century has expanded the concept of personal "needs." The work of economists Irving Fisher, Jack Hirschleifer, F. Thomas Juster, Robert P. Shay, and many others during the early to middle decades of the century formed the foundations of today's huge body of academic economic theory and empirical evidence on motivations for timing changes and associated risk of outcomes designated today as the microeconomics of finance. Fisher demonstrated that borrowing opportunities can enable an individual to undertake more productive investment and then borrow or lend to achieve more highly valued current and future consumption than would be possible without borrowing and lending opportunities. Hirschleifer extended this discussion to the case of imperfect capital markets where lending and borrowing take place at different interest rates. Juster and Shay extended it further to account for institutional characteristics of consumer credit markets including willingness of lenders to extend more credit only at higher finance charges and actual limits on borrowing posed by lenders. This work has been further extended by others.

As aficionados and practitioners of finance well know and understand, the economics and practice of return and risk analysis pioneered by these ana-

lysts can be complex and its mathematical academic language sometimes intimidating, but it is based upon a simple idea: Borrowers will borrow and lenders will lend when, for both parties, the risk-adjusted expected return from the change of spending timing exceeds its expected cost.

Twenty-first century minds have generally come to grips with these ideas, but it seems that vestiges of the ancient and medieval view remain in more modern dress. Psychological criticisms of the modern economic view of consumer credit use have also been around for a long time, but their latest imitation of the phoenix is a body of legal literature known as Behavioral Law and Economics (“BLE”). This is a loosely defined grouping of legal prescriptions based uncritically upon adopting into law some theoretical ideas from a relatively young branch of economics called Behavioral Economics. BLE focuses especially on a technologically newer manifestation of consumer credit use through credit cards.

More will be said about BLE later, but ultimately BLE suggests that there are limitations on the economic rationality of consumer borrowers that must be guarded against with regulation. The problem with BLE is that it conveniently ignores the well-developed ideas of traditional microeconomics without empirical evidence of the degree to which traditional economic theory needs adjustments to account for behavioral personal idiosyncrasies of individual consumer borrowers.

The special province of BLE involves credit card lending, an alleged special problem for consumers because of its ubiquity, easy availability, and immediacy. For BLE proponents, credit cards appear to be an entirely new area of lending in need of repair. It has become an area where they can argue that theoretical concepts based in psychology including “hyperbolic discounting,” “mental accounting,” “shrouding of fees,” and “nudges” should translate into new regulatory spheres.

A more complete view of credit cards within consumer credit is that credit cards are an outgrowth of ongoing technological change of lending in a credit industry looking for ways to reduce costs. As empirical evidence suggests, they have mostly just replaced much of small ticket household financing formerly undertaken by local banks, finance companies, and retail stores and dealers, plus assuming an increasingly important role as payments devices that involve credit only statistically but not behaviorally. To be sure, some consumers may behave psychologically irrationally in their use of credit cards, but the important question is the extent and overall importance of such behaviors. BLE should provide better empirical evidence of frequency and quantity before recommending legal changes to a system used successfully by millions of patrons.

And so the ancient and medieval tradition of distaste for “immoral” use of personal credit continues into modern times. This does not mean, however, that old ideas should be replaced uncritically by newer sounding armchair empiricism that quickly translates into legal prescriptions. More thoughtfulness is in order.

II. CONSUMER CREDIT GROWTH

Limited systematic empirical examination suggests that communications media's pronouncements about consumer credit growth have generally been dismal. This is not to establish a straw man for attack and it is difficult to estimate how influential such statements have been, if at all, but even the casual empiricism of asking one's neighbors for their views of the domestic consumer credit picture reveals the widespread notion that credit for consumers simply has grown too fast for too long. This claim is hardly new and it is easy enough to find examples over decades. This, in turn, raises another empirical question: what actually has been the growth picture in the consumer credit area?

Certainly in nominal terms consumer credit has grown in the postwar era. From a total of \$6.8 billion in current dollars at the end of 1945, consumer credit outstanding grew to more than \$3 trillion at the end of 2013. This clearly is a significant amount, which, of course, is not necessarily the same as being a meaningful worry. Many other economic magnitudes have also risen sharply in the years since World War II, including population, employment, income, assets, and wealth. Comparison of consumer credit to other economic magnitudes, rather than looking at absolute amounts of credit, helps to put the changes into better perspective.

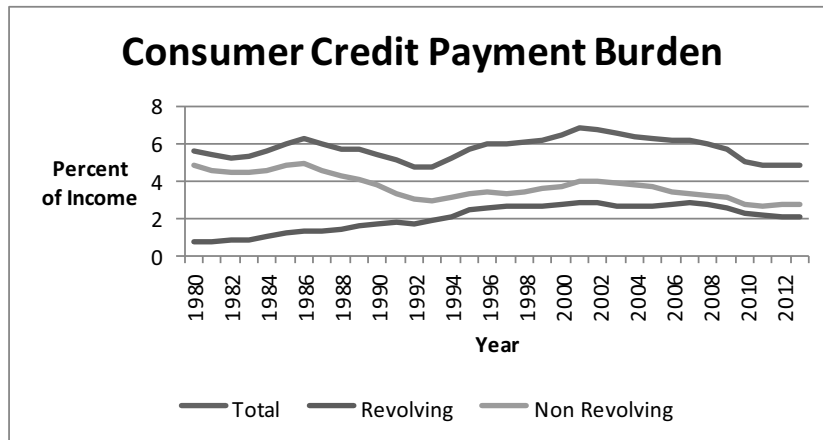
Before examining measures of credit growth, it is worth noting first that economic studies employing sophisticated theoretical and statistical approaches have failed to produce hard evidence from past experience that consumer credit growth has led to the biggest expressed concern: that such growth leads to decreases in future spending and causes or dramatically accentuates macroeconomic recessions. If anything, available evidence is to the contrary. Econometricians who have investigated the relationship between the payment "burden" of consumer credit arising from repayments and subsequent evidence of consumer spending have found that consumer credit growth actually is *positively* related to consumption in future periods. It seems that this positive relationship comes about because consumer credit rises when consumers are optimistic about economic prospects rather than pessimistic about present conditions, including the current burden of debt.

As indicated, it is possible to compare consumer credit versus other economic magnitudes in a variety of ways. Such comparisons show that after a post-World War II surge due to ending wartime restrictions on both durable goods like automobiles and appliances and also on credit, these comparative measures have risen hardly at all in decades.

One of the interesting comparisons over time involves a Federal Reserve measure of the ratio of payments to income known as the "Debt Service Ratio" ("DSR"). Analysts have contended that a measure of payments burden is better than a ratio of the *amount* of consumer credit outstanding because the payment ratio directly represents the relationship between outgoing resources necessary to avoid debt default and incoming resources available to meet the obligations.

Calculation of the consumer credit DSR over time shows that even with inclusion of student loan debts after 2003, the measure is trendless since first calculated for the year 1980, as shown in Figure 1:

Figure 1



Careful examination of the consumer credit DSR also shows that the DSR arising from credit card credit appears largely to be a replacement for declining DSR on older kinds of installment credit now employed less often for smaller and medium-ticket purchases (also visible in chart). This is not to say that no consumers have debt difficulties. During recessions, and especially at year-end holiday season, the news media are filled with feature stories about debt burdens and other sadness of the unemployed, but as sad as these cases are they do not represent anything close to the majority of consumer credit users. Including mortgage credit in a combined DSR for both kinds of credit raised the combined ratio about five percentage points between 1980 and 2007, but following the mortgage dislocations in the sub-prime area in 2008-2009, the combined ratio has returned again to its 1980 level (not in chart). Undoubtedly the flatness in the consumer credit DSR arises in part from the lengthening of consumer credit maturities that has taken place over time, but the result is that the consumer credit DSR is trendless.

Another way to look at consumer credit growth is to array yearly growth rates over a period of time to see if there have been anomalous (or even worrisome) sub periods. Doing so since 1946 makes it immediately apparent that credit growth has not been steady in the postwar period; annual growth rates for both consumer and mortgage credit have fluctuated over the postwar business cycles. Possibly more interesting is how the cyclical episodes have been relatively similar over time. Nonmortgage consumer credit annual growth peaked in each cyclical upswing after 1955 at roughly a 15 to 17 percent growth rate, with the all-time highs in the earliest postwar period when it was

responding to the end of wartime controls during the 1940s. Notably, there has not been a long-term sharp uptrend in growth rates in either the consumer or mortgage credit series. Although the relative consistency of pattern does not provide a forecast, it is at least an indication that recent growth patterns in consumer credit are not anomalous or startling in percentage terms. Consumer and mortgage credit grew rapidly in recent cyclical upswings, but they always have done so in upswings before falling off to growth rates around zero in downswings. Possibly the most noticeable change has been the sharp decline in mortgage credit growth after 2004 to negative territory beginning in 2008. Although the negative growth numbers for mortgage credit are new, a multi-year decline in growth rate is not.

There are further comparisons that can help to put credit growth in perspective and a variety of approaches to reporting the statistical comparisons. Fortunately, the various methods lead to the same general conclusion.

Debt at any instant is a certain amount outstanding. Quantities that are fixed at a point in time are known in economics as “stock” items. Common examples include the money stock (the amount of currency and deposits or other definition of money that the public holds at a given time), the amount of pension assets in individuals’ IRA and 401k accounts at the end of a year, the amount of bank assets subject to reserve requirements, the total public debt of the United States, etc. In contrast, the variation in a stock from one time to another is a change measure, an amount per period of time, and is known as a flow. Income, for example, is a “flow” measure, consisting of the change in a person’s or the economy’s financial condition (wealth) over a period such as a year. The change in credit outstanding over a year is another flow measure.

This distinction between stocks and flows immediately suggests four basic kinds of comparisons that might be made among economic quantities: stock to stock, stock to flow, flow to stock, and flow to flow. Discussion above focused on a particular flow to flow comparison, the ratio of consumer credit repayments to income (the DSR). When journalists compare consumer debt outstanding to something else, they often use a certain stock to flow ratio, debt outstanding relative to income. Both of these comparisons can be interesting, but they can sometimes be misleading, for example, the debt-to-income ratio ignores interest rates which have a major impact on how much principal consumers will borrow. Candidates for further comparisons include both stock and flow ratios of consumer credit to other important consumer balance sheet and income statement quantities: to specific assets, total assets, wealth, and the change in wealth (income). But without going into detail here on each kind of measure separately (information with charts that is available in the book), close examination of all four potential types of ratios for comparing aggregate consumer financial statistics (stock to stock, stock to flow, flow to stock, flow to flow) produces essentially the same conclusion concerning experience with consumer credit in recent years: recent trends are quite similar to experience in earlier decades.

In sum, none of the statistical methods of comparing consumer credit outstanding or changes in consumer credit outstanding produces a conclusion that recent experience is unusual or obviously problematic compared to historical trends. Furthermore, although economic studies including econometric studies of long-term growth of consumer credit have not been especially numerous over the years, there have been some serious studies in this area that go beyond just outlining the basic statistical trends as above. While most of these studies are rooted in the specific questions and issues of the times when they were written, serious analysts have reached similar conclusions concerning the generally benign nature of long term growth of consumer credit, regardless of the time period covered by their individual efforts.

From the discussion so far it is not obvious that consumer credit growth in the post World War II years warrants the gloomy assessments sometimes associated with it, whether expressed in dollars or in typical analytic form as an aggregate ratio of credit outstanding to some other relevant quantity. Neither the trends in the ratios themselves nor the conclusions of the serious analysts of consumer credit give clear reasons for the expressions of concern so often articulated in other quarters. There still are distributional questions, however, because, by themselves, the aggregates do not indicate how the debt and income may be spread among an economically diverse population. A potentially disturbing possibility is that income growth, for instance, may not accrue to the same consumers who increase their credit use. Credit use may only occur among lower income consumers, for example, while only higher income individuals receive pay raises and become better off financially, maybe never needing to use credit. Or, the relationships among credit users and income earners may change over time (for better or worse). Because of such questions, it is useful also to look at cross section evidence that arrays the holdings of debts and the reception of income.

The Federal Reserve Board's Surveys of Consumer Finances show that there has been growth in consumer credit use in all income and age segments from 1951 to 2010. Among income quintiles, the greatest relative growth in frequency of credit use occurred in the two lowest income quintiles between 1951 and 1963, but since then growth in the credit using population has been slight in these groups and only moderate in the upper income groups. Each of the three highest income groupings registered half or more of their members as consumer credit users as long ago as 1951, and the proportion in the third and fourth quintiles reached two-thirds by 1963. Only the two highest income groups show any noticeable growth in the proportion of consumer credit users since then, at about five percentage points in both groups. Examination of the shares of consumer credit owed by the various income quintiles also shows great stability since the 1950s.

In conclusion, consumer credit use has grown sharply in the post-World War II era, but not very much relative to income or assets since the early 1960s. Historical patterns in these ratios have been intensely cyclical, however, which likely at least partially explains why there are expressions of concern

when they rise, despite lack of firm evidence that rising debt ratios have led to economic calamity. Debt growth has occurred in all income and age groups, but the bulk of consumer credit outstanding currently is owed by the higher income population segments, much as in the past. The two lowest income quintiles taken together owed about 23 percent of consumer credit in 2010 about the same as in 1956, although there was an uptick for the lowest quintile in 2010. The share of consumer credit outstanding owed by the upper income fifth of the income distribution was 33 percent in 2010, not much different from 1951, despite interim fluctuations.

III. BEHAVIORAL ANALYSIS AND CONSUMER CREDIT USE

During the post–World War II period, the view that consumer credit use is a normal development in a modern economy seems to have gained traction with the public at large. In large part, this new view is likely a result of decades of experience with consumer credit that has demonstrated its usefulness. There are risks with consumer credit, to be sure, but most middle-class consumers do not have serious credit troubles, and they apparently view credit availability reasonably favorably.

Widespread acceptance of consumer credit is observable from public opinion surveys. Surveys also show that consumers appear well able to differentiate in their minds among acceptable purposes for borrowing; some purposes are more acceptable than others and have been so for a long time. These views suggest a degree of thoughtfulness and deliberation in credit decisions, but this kind of differentiation also suggests that consumers' analyses of their credit decisions may not be entirely consistent with a strict interpretation of economists' axioms of rational choice. Instead, these views suggest that when making credit decisions, consumers may use heuristics ("rules of thumb") that simplify decision making or employ some kind of mental accounting or sorting for making distinctions. Such behavior may be purposive, intelligent, and utility enhancing but still fall something short of the extensive weighing of alternatives underlying the economic model of utility maximization. This fact alone encourages further consideration of the underlying psychological conditions for consumers' choices.

Development of psychological aspects of the theory of consumer credit demand falls into two broad categories: (1) analyses based on psychologists' models of the cognitive process and (2) economic hypothesizing about credit use based on assumptions about consumers' cognitive biases. Analyses in the first category are largely empirical and provide insights into the processes that lead to economic decisions. Analyses in the second category have generated many recent theoretical discussions, mostly about credit card use, but to date have produced relatively few empirical generalizations about consumers' credit or credit card use behavior. Nonetheless, they form a new genre of consumer credit analyses in recent years. A prominent subset of theories in the second category called "Behavioral Law and Economics" ("BLE"), appears to be

mostly concerned with implications of suggested cognitive biases for legal and policy prescriptions, rather than development of either theory or empirical evidence *per se*. As discussed previously, some consumers may sometimes behave psychologically irrationally in their use of credit cards, but BLE should provide better empirical evidence of frequency and quantity before recommending legal changes to a system used successfully by millions of patrons. Only a little more about the offshoot BLE will be said here.

Actually, behavioral economists and psychologists have studied consumers' credit decisions for decades, especially using consumer survey techniques. Their studies have been empirical, and many are concerned with the extent to which consumers' behavior is rational. Standard economic theory is concerned with specific goals such as utility maximization, evaluation of all available alternatives, choice of the alternative that best achieves the goal, and consistency in choice. In contrast, behavioral economists expand this concept of rationality. They view rational behavior as purposive and deliberative but not necessarily strictly optimal. They note that consumers often simplify, taking shortcuts and using "rules of thumb." Consumers are often satisfied to take small steps toward goals (adaptive and satisficing behavior) rather than making the effort to achieve the optimum. Culture, group membership, attitudes, past experience, and even biases may influence the decision process.

Survey research on the process of spending in large part supports the economic analyses that treat consumer credit as a part of consumers' investment-consumption decisions. Surveys have found that the bulk of consumer credit arises in the process of purchasing household durable goods and services that do not fit conveniently into monthly budgets. Consistent with the theories of the economists, surveys find that credit use is greatest in early family life cycle stages, particularly in families with young children. Such families typically start with relatively low stocks of durables and can often obtain high rates of return on additional household investments.

A major additional focus of the survey research has been to investigate the extent to which consumers' durable goods purchasing and financing decisions are deliberative and rational. The research indicates that few purchases include all of the elements of rational decision making, namely, planning for purchases, extensive search for information, formulation of evaluation criteria, and careful consideration of alternatives before making decisions. As indicated, consumers often simplify, take shortcuts and use rules of thumb (heuristics). Consumers may focus on one or a few product characteristics or rely on the experience of friends, for example. Nevertheless, evidence suggests that most consumers use one or more elements of deliberative behavior in decisions about consumer durables and credit.

The research has identified several circumstances that lead to more or less deliberation in durable goods purchases. Situations in which consumers tend to follow more closely the economists' fuller model of rational decision making include purchase of an item that is considered expensive or particularly important, purchase of a new or unfamiliar product, dissatisfaction with a pre-

vious purchase, and a strong new stimulus that causes uncertainty about previous attitudes or experience. In these situations, consumers are more likely to gather additional information, formulate or revise evaluative criteria, and deliberate more about alternatives, although they may still take shortcuts, simplify, or use heuristics. Few consumers collect all available information, carefully consider all possible choices, or use compensatory decision rules that weigh all product characteristics. The economic model of rational choice suggests that they may not want to collect all available information because the collection and decision process is itself costly. Learning about all product characteristics, identifying sellers, collecting information about prices and characteristics of specific product choices, and evaluating alternatives are time-consuming and may include explicit expenses. This is consistent with the hypotheses of economists that consumers will collect additional information only as long as the cost of the search is less than its benefits.

In contrast, consumers tend to limit extensive deliberative behavior in situations where they perceive a special opportunity that would not be available in the future, have an urgent need, or are satisfied with a previous purchase of the item. Such decisions still may include important elements of rational decision making, however. Even consumers who perceive an urgent need, such as a need to replace an important household durable good or an automobile, may recognize the problem in advance and take steps to prepare for the eventual purchase.

Survey work has also provided evidence that regular payments have had an additional role in budgeting, called "precommitment" or "mental accounting" in some studies. The practice of precommitment can involve costs, but evidence suggests that many consumers are willing to pay to protect themselves against their own bad habits. While, strictly speaking, such behavior does not represent definitional economic rationality, it does not imply irrationality, either, if that term means uncontrolled credit use outside the general boundaries posed by the economic theory devised by Fisher, Hirschleifer, Juster and Shay, and others.

More recent work by Kahneman and Tversky and others on decision making under risk and uncertainty has further enhanced the interest of economists in psychological influences on economic choices, including credit use. Much of this work involves an experimental approach rather than surveys and does not involve specifics of credit use per se, although it has been influential in developing hypotheses in this area. Resulting theorizing about such things as various cognitive biases that result from individuals' use of heuristics (simplified decision rules), a tendency for individuals to prefer avoiding losses more strongly than acquiring gains, and experimental and other evidence suggest that individuals discount proximate outcomes more than distant ones. If discount rates vary by time horizon, then the choice between two options might differ depending on when the choice is made. Such behavior might lead individuals to deviate from optimal intertemporal allocations depending on the time period in question. This possibility immediately raises questions about

such things as shortsightedness and self-control. New behavioral theories of this kind can challenge assumptions about rationality in economic decision making, including decisions about consumer credit use.

But evidence suggests that experimental studies of cognitive biases are sensitive to the format, context, and content of the problems presented to participants. They suggest that considerable care is required to design meaningful experimental questions and to produce appropriate conclusions. Some of the problems presented to participants in experimental studies likely do not reflect the problems actually experienced by most individuals in making decisions under uncertainty, and participants in experimental studies may not use the same decision processes that they use in making actual decisions. Experimental problems often appear more similar to test questions than choices that consumers actually face in the markets. Hypothetical situations are likely perceived as such by study participants. And it seems unlikely that participants in experimental studies view the consequences of their choices as very important. In an experimental study, as opposed to in the “real world,” there is little cost to making an error and not much reward for efforts to provide a correct response. Consequently, results of the experimental studies should be interpreted with considerable caution and cannot be applied to specific problems without an understanding of the decision process and the environment.

Although it seems reasonable to conclude that individuals sometimes do make cognitive mistakes, we cannot directly conclude that all, most, or even many human decisions are influenced by cognitive biases, however. Further, individuals may be predisposed to impulsive behavior, but they also have the capacity to exert self-control to implement forward-looking plans. Self-control requires actively maintaining attention to the plan. An individual facing an impulse might yield to the impulse if it does not perturb the plan too much. To be effective, self-control requires that the internal inhibitions become stronger as awareness of the cost of impulsive behavior increases. It is not clear that participants exert the same cognitive efforts in experimental situations that they exert in actual situations where commitments in money and duration are great, past experience and information are insufficient or obsolete, and outcomes of previous decisions are regarded as unsatisfactory. Assessing actual decisions requires understanding the cognitive process and the environment in which the decisions are made, as marketers have pointed out for decades with buyer behavior models and derivatives of them.

Thus, it is worth remembering the definition of rationality as behavior aimed to achieve one’s goals or objectives. In many situations simple heuristics can often perform as well as rules based on more detailed definitions of rational decision making. Studies in a variety of areas present evidence suggesting that heuristics provide accurate predictions in many areas but require less information to implement, although, to date, the applications of theories have generally been to relatively simple problems. Theories on use of specific heuristics in consumer credit decisions or cognitive biases arising from such use have not specifically been tested.

Concerning time discounting, the evidence from a variety of studies suggests that individuals tend to discount proximate prospects more highly than more distant ones; but for long-run time horizons (that is, greater than a year), discount rates appear to be approximately constant, the latter consistent with the standard expected utility model and economists' notion of rationality. The tendency to discount proximate amounts more highly can cause harm. Sometimes the harm is great, as in the case of addiction, for example, but individuals make numerous intertemporal decisions, and in most cases, they do not suffer any apparent harm. Individuals have cognitive control structures that enable most of them to resist temptation for impulsive immediate gratification and undertake actions to achieve goals. Individuals can also choose various external precommitment mechanisms to control impulsive behavior. External controls may not always produce optimal outcomes, but they represent purposeful actions to achieve desired goals. Thus, concluding that hyperbolic discounting is in itself always irrational or that individuals generally do not make purposive and deliberate intertemporal choices is not justified at this time.

Regarding consumer credit, evidence is limited, but empirical evidence on credit card behavior, suggests that consumers generally behave as economic theory predicts and that when consumers make mistakes, the mistakes are small or are usually corrected when large. Consequently, it is not at all clear that behavioral research undermines neoclassical economic theory of credit use as much as it enriches and enhances it. Instead, the behavioral analyses suggest the details of the elements of rational economic choice and where the theory should accommodate differences. More on this point will become known in the future as economists model consumer credit behavior more fully, employing more fully the insights from behavioral sciences and testing the enlarging body of theory with specific empirical data.

Specifically concerning BLE, although proponents have pointed to such discussion as a basis for government regulation of credit cards, they focus on theoretical discussion and *a priori* assertions but provide no empirical underpinning for the arguments. Rather, they hypothesize welfare-reducing behavior by consumers and use several *ad hoc* explanations based on behavioral economics to conclude that these welfare-reducing practices persist because credit card issuers prey on consumer biases. This lack of empirical evidence is especially troubling in light of the extensive existing empirical literature not discussed in BLE.

In sum, behavioral research indicates that consumers do not always make the cognitive efforts required for an extensive decision process. Individuals often take shortcuts, simplify, and use heuristics. Cognitive effort tends to be reserved for situations where commitments in money and duration are great, past experience and information are insufficient or obsolete, and outcomes of previous decisions are regarded as unsatisfactory. In situations where consumers have previous experience and are satisfied with past decisions, consumers often make choices with little further deliberation. That cognitive bi-

ases and time-inconsistent discounting exist is well established in the behavioral literature. Some research suggests that these psychological considerations could influence consumers' credit behavior. The extent to which cognitive biases and time-inconsistent discounting affect actual credit decisions is not known at this time.

But, evidence from analyses of actual credit card behavior indicates that consumers are sensitive to price, consistent with the predictions of economic theory. When a credit card company increases the interest rates on an account, consumers reduce new charges, reduce existing balances, and shift charges to other credit card accounts, and over the course of a year, they reduce total credit card balances from the level before the price increase. Based on subsequent account use, consumers generally make cost-minimizing choices, trading off interest rates and annual fees when choosing new credit card accounts. When they make mistakes, the mistakes are usually relatively small. If mistakes are large, consumers generally correct the mistakes. Although some consumers do not correct large mistakes, persistent large mistakes are not the rule. Analyses of credit card behavior based on survey data also suggest that consumers are sensitive to costs and do not incur costly mistakes. And by far most consumers believe that credit cards provide a useful service and are satisfied with their dealings with credit card companies. Thus, neither behavioral nor conventional evidence provides much support for the conclusion that market failure is pervasive.

IV. CONSUMERS AND HIGH COST CREDIT

Some consumer credit products have gained special notoriety in recent years because of their apparently high prices, as evidenced by high annual percentage rates and their use by lower-income, credit-impaired, or other less fortunate consumers. The products in question include pawnbroker loans, some kinds of small personal installment loans, payday loans, subprime credit cards, automobile title loans, and income tax refund anticipation loans. Although they are sometimes called "fringe" products because of the relatively small amounts of money typically involved, they are used by millions of people every year.

Prices for these fringe credit products are indeed high when expressed in terms of annual percentage rates required under Truth in Lending. Finance charges are large relative to the small loan amounts, and terms to maturity are short. Under these circumstances, annual percentage rates often exceed 100 percent. Not surprisingly, triple-digit interest rates invite widespread criticism. The critics of high-rate credit products often contend that consumers would be better off without such borrowing opportunities. They see little or no benefit to using high-rate credit and assert that high-rate credit products contain great potential to harm consumers. They declare further that consumers using such products often are uninformed or sometimes misled, often supporting these views using anecdotes and stories. There clearly are instances when consum-

ers have suffered harm and have been uninformed or misled when they used these products, but systematic evidence on frequency of problems or the extent to which use of high-rate credit may be informed has been limited. That these products visibly remain in demand, and even seem to be gaining in popularity, suggests the usefulness of further analysis.

Review usefully can begin with the economic intertemporal consumption and investment decision model originally developed by Fisher, Hirshleifer, Juster and Shay, and others and discussed previously. This economic model of consumer credit use predicts the characteristics of consumers that may benefit from high-rate credit. Then the psychologists' model of the decision process can provide criteria for assessing the extent to which these consumers' behavior is purposive and intelligent.

In their economic analyses of the consumer's credit decision, Juster and Shay explained why consumers are sometimes willing to borrow at high rates of interest. First, as discussed earlier, many durable products and services purchased using credit provide benefits over a period of time and that for some families; the implied rates of return for these benefits can be quite high. But because income and accumulated savings are finite, lenders limit the amount of credit they are willing to offer any consumer. Consequently, the rate of return from additional investment in durables may exceed the marginal borrowing cost from primary lenders but still be less than the cost of sacrifice of current consumption of other things or reduction in savings necessary to acquire additional durable goods. When this situation occurs, consumers are said to be credit constrained or rationed by the primary lenders. Specialized secondary lenders willing to lend small amounts at relatively high rates can relax the credit constraint and increase utility, but the rates of charge can be high due to the necessity of recovering the operating cost of production from relatively small balances of the credit outstanding.

Such rationed borrowers are likely to be in early family life cycle stages. For them, rates of return on household investment tend to be high. They tend to have relatively low or moderate current incomes and little discretionary income, making the sacrifices in current consumption to pay for large expenses personally costly. And because of their moderate incomes and young age, rationed borrowers generally would not have accumulated large amounts of liquid assets. At this stage in the life cycle, their liquid asset holdings have a high subjective yield because of precautionary savings motives. As a result, demand is high and supply is low, resulting in higher prices, especially for unsecured credit.

Unrationed borrowers, in contrast, likely are more often in later family life cycle stages or have relatively high incomes. Unrationed borrowers in later life cycle stages may have relatively few high-return household investment opportunities. Higher income and more available savings may provide discretionary amounts that allow for relatively large expenditures without costly reductions in current consumption. For them, subjective yields on liquid assets can be substantially lower for unrationed borrowers than for rationed

borrowers. Availability of low-cost discretionary income and liquid assets would make unrationed borrowers generally unwilling to pay high interest rates for additional credit.

For consumers' individual reviews of their situations, the benefits from durable goods acquisitions can often be measured in dollars as saved costs (for example, home appliances and repairs) or as enhanced opportunities (for example, transportation from automobiles). Likewise, benefits of using a short-term loan may also be analyzed in terms of the costs of some market alternative. For example, a short-term loan may be used to avoid a late payment on a utility bill, a foregone car repair that results in getting fired, or some other costly outcome, or to take advantage of a one-time opportunity like a sale. Even at a high rate of interest, therefore, high-cost credit might still be less expensive than alternatives.

Reviewing available empirical evidence about the users of high-cost credit products shows that consumers who use different types of high-rate loans tend to be different in age, life cycle, and income groups that are associated with strong demand for credit and are often rationed. They mostly are relatively young, are in early family life cycle stages, and have lower or moderate incomes, depending on the product. Some of these consumers (payday loan and tax refund anticipation loan customers with bank accounts) are more likely to use closed-end credit than all families on average and are apt to have higher debt burdens than families with debt generally. Others (pawnbroker, tax refund anticipation loan customers without bank accounts, and rent-to-own customers) are less likely than all families to use mainstream credit products. Regardless of their use of mainstream credit products, many high-rate credit customers have characteristics that limit their access to credit, and most have experienced turndowns or perceive that they are constrained. Thus, the consumers who use high-rate loans are generally ones who economic theory predicts might benefit from relaxation of credit constraints. In itself this does not indicate that their use of such credit is rational, but it does suggest that their circumstances are such that use of high-APR credit may well be utility-increasing.

To understand consumers' choices involving high-rate credit products, researchers have turned to cognitive models of consumers' decision processes from psychology, including buyer behavior models and related constructs. Viewed this way (and discussed earlier), the consumer's decision is a process that occurs over several stages: problem recognition, internal and external search for information, choice, and outcome evaluation. These stages are interrelated, with feedback occurring throughout the process. Developments during each stage may cause the process to stop, move to the next stage, or proceed immediately to the purchase. Consumers may simplify, use heuristics, or take shortcuts during the decision process. They and economists also recognize that consumers may not obtain complete information about alternatives before making decisions. In the economist's framework, acquisition of infor-

mation may be costly. A consumer will acquire additional information only if its expected benefit exceeds the cost.

In general, these hallmarks of extended decision-making processes do not describe the circumstances typically involved in choosing high-rate credit products; high-rate credit products have characteristics associated with limited decision processes. Concerning product characteristics, most are relatively short term. Also, because loan amount is usually small, the finance charge is high relative to loan amount but not generally relative to the borrower's monthly income. Deliberation for such purchases may be strongly focused on one aspect of the purchase to the exclusion of others and still be purposive and entirely rational. These psychology-based behavioral models suggest that extensive collection of information and weighing of all available alternatives may not always be necessary for purposive and intelligent decisions. In fact, focusing on the psychological aspects of the decision to use credit for purchasing durable goods on credit, pioneer analyst George Katona noted in 1975 in his classic *Psychological Economics* that if careful deliberation were defined as including all features of decision making—consideration of alternatives and consequences, discussion with family members, information seeking, and concern with price, brand, quality, performance, special features, and gadgets—the conclusion would emerge that almost all people proceed in a careless way in purchasing large household goods. This conclusion, however, seems unwarranted, especially for shorter-term purchases of a more urgent nature.

Further, situational factors may also limit decision processes. A short term to maturity makes high-price credit products more suited to addressing temporary shortfalls in funds than financing investment in durable goods that might last years. Temporary shortfalls may often be the result of unexpected expenses and may therefore be viewed as urgent. Moreover, short-term use to address temporary shortfalls in cash may involve relatively short time periods since previous decisions. In such situations, consumers may perceive that information obtained from previous decisions is not obsolete.

With this as background, empirical research evidence shows that many users of high cost “fringe” credit products show signs of deliberation in their decisions, but most probably do not undertake an extended decision process. Many customers have previous experience with the product and may not exert much effort in subsequent decisions. Relatively low loan amounts and short terms to maturity also may contribute to lack of awareness and lack of deliberation. Customers are largely satisfied with their decisions and generally do not believe that they have insufficient information. In this way, decision processes for high-price credit products do not appear to be much different from decision processes for mainstream credit products. The decision to use high-price credit typically is a result of the consumer's situation rather than a lack of knowledge or information.

Evidence also shows that most consumers using high-rate credit products are aware of the cost of such credit. They generally are able to recall reasonably accurate finance charges (in dollar terms) but are largely unaware of annu-

al percentage rates for recent loans. For example, while few borrowers can accurately state the APR on a payday loan, the overwhelming majority of payday loan borrowers are aware that the cost is approximately \$15 per each \$100 borrowed. Because most high-rate loan products have a short term to maturity (a few weeks), however, knowledge of the finance charge is generally sufficient for making informed decisions and knowing the *annual* percentage rate may not be very helpful for a short-term loan. Under this circumstance, consumers can evaluate costs and benefits without consideration of their timing. Net undiscounted benefits will not differ much from net present value of benefits.

To date, efforts to determine whether the economy as a whole actually benefits from high-rate credit products have focused largely on payday loans. They have examined a wide variety of outcomes, many of which are quite far removed from the circumstances of the payday loan decision. That a \$300 two-week loan used by a very small proportion of the population could significantly influence outcomes such as property crime rates, bankruptcy rates, job performance, or check returns seems almost incredible. To be convincing, these studies must ensure that the differences in outcomes are caused by differences in payday loan access rather than something else and that the consumers who have access to payday loans are similar to consumers who do not.

It is not clear that these studies have succeeded. State laws that regulate payday lending are the product of a political process that also produces laws affecting many other aspects of the local economic and social environment, including the availability of other financial services, quality of educational services, and types of employment opportunities. A state that sharply limits personal or auto loan rates, for example, would hardly be inclined to authorize rate ceilings that permit payday lending. Geographic proximity or accounting for differences in a limited set of economic or social variables is unlikely to eliminate entirely the effects of other influences on outcomes. Thus, while suggestive, these studies are not fully convincing.

There clearly also is considerable room for more micro-oriented research into specific effects of availability of high-rate credit, although such studies can be very expensive and difficult if they involve survey work. Nonetheless, it is likely there will be more of this work in the future.

V. GOVERNMENT REGULATION OF CONSUMER CREDIT

Credit for individuals is as old as recorded human history, and so is the ongoing interest of governments in controlling it. Ancient laws of Babylon, Greece, and Rome all contained regulation of lending and borrowing by individuals, and some historians have conjectured that centralized tribal control of credit extends even deeper into antiquity. Much later, in the Middle Ages, the Christian church contended that charging interest on loans was a moral evil (usury) and therefore prohibited, ultimately based on restrictions found in its own antiquity, the ancient books of the Old Testament. Overlaps between

religious and civil authority during the Middle Ages guaranteed that development of lending and borrowing relationships in western Europe remained complicated for centuries, producing legal difficulties extending even into modern times.

As notions of morality based on religious principles have faded over time as a foundation for commercial restrictions, concern has developed in some quarters that individuals still need government protection in their credit relationships for two further reasons: to shield them from inability to understand fully the implications of the credit transactions they enter into and to help them avoid possible inappropriate behavior by questionable credit vendors in the marketplace. In this view, the term *consumer protection* in credit matters refers to various governmental means of altering prevailing conditions and practices in the credit marketplace rather than absolute prohibition of credit relationships. Today, many observers of consumer credit markets believe that they are neither perfectly competitive nor perfectly uncompetitive, and, consequently, they recommend regulatory roles for both competition and government.

Whatever the influences, reasoning, and circumstances leading to current conditions, it is apparent that few areas of the American economy are as closely regulated as consumer credit. Until the late 1960s, governmental consumer protection in credit markets was mostly the province of state agencies, but today both federal and state authorities are involved. Consumer credit regulation evolved during a time when the federal system of governing left most aspects of local commerce as the province of state governments, and so early forms of regulation were at the state level. Federal activities for consumer protection began in 1968, with enactment of the federal Consumer Credit Protection Act on May 29 that year, and with its most important provision, the Truth in Lending Act, effective July 1, 1969. The Equal Credit Opportunity Act and other federal legislation followed in the 1970s. By 2010, the growth of federal regulation led to establishment of a new federal Consumer Financial Protection Bureau (CFPB), with official opening date July 21, 2011. Historically, regulation of pricing terms on consumer credit has been the province of state regulation but with federal regulators today waiting in the wings. It is possible, even likely, that federal activity in this area could increase substantially in the future.

Usury laws in Britain served as the model for the American colonies in the eighteenth century. The colonies (and later the fledgling states) adopted a usury ceiling of 6 percent as a carryover of the prevailing 5 percent ceiling in Britain at the time, with an extra percentage point added to help raise capital. For the next century, ceilings on loan interest rates were the rule throughout the states, although with wide variance in levels. The western states, where capital was in great demand and supply scarce, generally adopted higher rate ceilings and weaker penalties for violation of the law than the eastern states, where capital was more plentiful. A lack of hard (coin) money in the west also

necessitated a greater reliance on credit, making the inevitable shortages that accompanied interest rate and other lending restrictions more painful.

Legal limits in the colonial period and the early republic sometimes exceeded prevailing market rates and thus were not binding. In some cases states raised or abolished rate ceilings so that they no longer placed constraints on the market. Ceilings also were commonly evaded and were difficult to enforce, although during the colonial period and the 19th century there was not much consumer credit under modern definition available anyway.

But during the early modern industrial period, high rates of interest, abusive collection practices in some cases, and a perception that small loan cash lenders preyed on the poor gave rise in the 1880s to calls for stricter laws and more vigorous reform. Most of the states that had earlier repealed usury laws reinstated them over the next two decades. Generally, these reform efforts were ineffective and counterproductive. Lenders often changed the details of the transaction to place it outside the purview of the revised law; and borrowers, unwilling to risk losing access to credit, were often reluctant to complain to enforcement authorities.

The ineffectiveness of restrictive laws in curbing illegal lending gradually led to an acceptance of the view that laws should regulate but not prohibit cash loans, either explicitly or through restrictions that made small, relatively short-term unsecured loans economically infeasible. Around the turn of the century and especially after 1910, states began passing specific legislation to create a regulated lending industry. Early efforts typically were viewed as consumer protection. Efforts of entrepreneurs and joint efforts with social reformers during this period led to the beginnings of philanthropic lending, Morris Plan industrial banks for working people, credit unions, and the regulated small loan industry. By the end of the first half of the twentieth century, consumer credit reforms had created the institutional structure for modern consumer credit markets, excluding three-party credit cards which also depend on more modern data processing and communications. Nonetheless, evidence shows that rate ceilings continued to influence development of the institutions and markets.

Economists have demonstrated convincingly the complicated nature of the theory of setting appropriate rates to produce favored social outcomes outside of the market context. Various government attempts over the years have demonstrated the practical difficulties, especially if one of the goals involves providing for credit availability at reasonable rates to all risk classes of borrowers. Theoretical work shows that interest rate ceilings can affect the distribution of credit across risk classes of borrowers in ways that are difficult to predict. Depending upon competitive conditions, some risk classes of borrowers may sometimes benefit and others may be harmed.

For this reason, economists have been skeptical that authorities possess the analytical capabilities to assess the supply and demand conditions, price elasticities, and cost conditions in credit markets in order to set ceiling rates in a way that would reduce monopolistic power and produce competitive out-

comes for all market participants. They have noted also that even a lender's experience with customers provides information for assessing risk that may not be available to the authorities. Furthermore, they pointed out that in many situations, credit is provided in conjunction with the sale of goods, making evasion of rate ceilings relatively easy. And so interest rate ceilings may not be very effective for controlling such sources of market power.

In addition to the obvious direct impacts on borrowers and lenders of these attempts to manipulate marketplace rates, the differential ceilings according to institutional class of lender found in many states have had the more subtle effect of actually reducing marketplace competition. Fragmented markets for consumer credit and the reduced competition they entailed encouraged higher, less competitive prices in each fragment. For unsecured personal loans, rate ceilings for finance companies typically were higher than those for banks, particularly for small loan sizes. Rate ceilings for credit unions were usually closer to rate ceilings for banks, although most credit unions enjoyed cost advantages over the other institutions. As a result, banks tended to make larger, lower-cost loans per loan dollar, and credit unions and especially finance companies tended to make smaller, higher-cost loans. In 1971–1972, the National Commission on Consumer Finance (NCCF), a federal government study commission authorized by the federal Consumer Credit Protection Act, verified important facts about consumer lending markets at the time:

- 1) Market rates did not always rise to ceilings as broadly believed, which suggests that prices for consumer loans are set by supply and demand factors.
- 2) Differential rate ceilings by institutional class segmented markets and reduced competition.
- 3) The degree of competition influenced both rate and credit availability.
- 4) Rate ceilings promoted credit rationing.

Summarizing the empirical evidence, the National Commission and other researchers have found empirical evidence of a variety of problems with rate ceilings. None of the findings is encouraging about the overall usefulness of rate ceilings as a consumer protection.

First, differential rate ceilings by institutional class of lenders have segmented consumer credit markets, thereby reducing the ability of different lender types to compete with one another. Thus, interest rate regulation has tended to foster market power of lenders, one of the alleged problems that rate ceilings were intended to remedy.

Second, evidence suggests that low rate ceilings reduce the quantity of consumer credit. This result argues against rate ceilings producing more com-

petitive outcomes than markets in which rates are not restricted. Evidence further suggests that competitive influences have always existed in consumer credit markets, both within lender type and across lender types, despite the adverse effects of market segmentation arising from rate ceilings in the past.

Third, interest rate ceilings do not affect all consumers equally. Higher-risk consumers are more likely to experience a reduction in credit availability than lower-risk consumers, with lower rate ceilings affecting greater percentages of the risk distribution of consumers than higher rate ceilings. Lenders may offer potentially rationed borrowers less risky loan contracts, such as contracts requiring larger down payments or with shorter maturities.

Fourth, high-risk consumers also have obtained credit from sellers who reallocated part of the cost of credit to product prices. For example, a department store that sold appliances on credit might offset the inability to charge a market rate of interest by raising the sticker price of the goods financed. The presence of substantial numbers of cash customers (or lower-risk credit customers who can obtain credit elsewhere) limits mainstream sellers' ability to reallocate credit costs in this way. This has given rise to specialized retailers in certain areas without substantial numbers of cash customers or others with access to outside credit sources. Those sellers willing to specialize in credit sales to high-risk consumers face little competition from mainstream sellers and sometimes have been able to charge very high prices for the goods purchased.

Finally, high-risk consumers may obtain credit from friends or family, high-APR lenders, and illegal lenders. Limited financial resources and high-interest or noninterest prices for these sources suggest that high-risk borrowers will not obtain as much funds at a lower price from these sources as from forgone institutional installment credit. This outcome may prevent some perhaps excessive consumption, as some proponents of interest rate ceilings have argued, but it is likely that much investment in higher-quality household durable goods is also forgone. Since household investment can have high rates of return and be wealth-increasing, such rationing likely harms many rationed consumers.

CONCLUSION

In conclusion, the book discusses these and many other ideas at much greater length. To the authors, one of the fascinating aspects of discussion about use and users of consumer credit is that the debate about credit use is so old. Because recorded government decrees have regulated use of credit for almost four thousand years, we know that people have sought the benefits of personal credit use and paid its costs for at least that long and probably much longer. Personal borrowing and lending likely extend at least to Neolithic times when debtors found themselves in need of or actually using resources prepared by or belonging to someone else and a transferal bargain or a dispute ensued. Centralized regulation of such borrowing probably extends to the

same time when some tribal chieftain became tired of arbitrating such matters and set up rules for their orderly undertaking and resolution.

Another fascinating fact is how the core economics of credit using remain basically the same over the millennia, even if much updated in terms of actual mechanics and institutional arrangements. The marketplace dynamics change over time and so do the analytic methodologies used to examine them. But even as the specific policy matters ebb and flow, the underlying questions and responses have great staying power. Central among them have always been the issues of costs and benefits, risks and rewards, the present versus the future, rationality versus irrationality, understanding versus ignorance, and freedom versus control.

But probably the most noticeable feature of consumer credit, its institutions, its complements, and its substitutes is its ubiquitous nature that can only arise from its underlying inherent usefulness in many situations. It still seems no one loves creditors, however, although few want them to disappear from the marketplace either. Like almost every consumer product or service ever invented, consumer credit clearly has its place in civilized society, even if something can go wrong after the fact of an account opening. Probably no amount of discussion, controversy, or regulation can ever solve these concerns completely. The authors merely hope that the discussion here and more so in the book can put this ubiquitous product into better and useful perspective.

ARE BIGGER COMPANIES BETTER FOR LOW-INCOME
BORROWERS?:
EVIDENCE FROM PAYDAY AND TITLE LOAN
ADVERTISEMENTS

*Jim Hawkins**

INTRODUCTION

Payday lending and title lending markets are dominated by large lending companies. While there are certainly some companies that have just one storefront, the vast majority of customers turn to very large lenders. For instance, in Houston, Texas at the time period studied in this Article, 85.96% of the payday and title lending locations are parts of companies that have more than fifty storefronts in Texas. At the national level in 2008, sixteen large payday lenders made up more than 50 percent of all stores.¹

Not only are markets currently dominated by large lenders, changes in payday lending regulation have, perhaps inadvertently, caused large lenders to occupy even more of the market. Since the Colorado legislature enacted payday lending reforms, “larger operators have increased their market share in the state. Before the change, seven of the largest operators owned 59 percent of Colorado stores. By the end of 2011, their market share was 69 percent, and more recent data indicate that figure has risen to 73 percent.”² Similarly, commentary predicts that the Dodd-Frank Act favors large lenders because these lenders can absorb the cost of compliance with the law better than small lenders.³ The Consumer Financial Protection Bureau is

* Associate Professor of Law, University of Houston Law Center. For help on this article, I have many people to thank: Devon Arnold, Valli Challa, Pamela Foohey, Evan Harlow, Courtney Hawkins, Alex Horowitz, Nathan Innuria, Katie Jackson, Charlette Jefferson, David Kwok, David Fagundes, Nathalie Martin, Eboni Nelson, Teddy Rave, Jill Robinson, Brittany Vanek, Ben Wallen, and participants at the 10th International Conference on Contracts and at a workshop at the University of Houston Law Center.

¹ Robert B. Avery & Katherine A. Samolyk, *Payday Loans versus Pawn Shops: The Effects of Loan Free Limits on Household Use* 9 (Sept. 9, 2011), at http://web.law.columbia.edu/sites/default/files/microsites/transactional-studies/files/10PDL_averysamolykpayday.20110909_0.pdf.

² PEW CHARITABLE TRUST, *PAYDAY LENDING IN AMERICA: POLICY SOLUTIONS* 19 (2013), available at http://www.pewtrusts.org/~media/legacy/uploadedfiles/pes_assets/2013/PewPaydayPolicySolutionsOct2013pdf.pdf (citation omitted).

³ Amy J. Schmitz, *Females on the Fringe: Considering Gender in Payday Lending Policy*, 89 CHI. KENT L. REV. 65, 97 (2014) (“[S]ome have criticized Dodd-Frank as favoring large [payday] lenders over smaller businesses that cannot shoulder the costs of increased regulation.”).

poised to regulate payday lenders with rules that may unintentionally give large lenders a competitive advantage. When the Bureau met with small business owners pursuant to the Small Business Regulatory Enforcement Fairness Act, the businesses almost universally told the Bureau that the proposed regulations would shut them down.⁴ A recent industry study claims that 82% of small payday lending businesses will close as a result of the regulations.⁵

But before we implement regulations that favor large lenders, we need to ask: Is consolidation a good thing for the consumers in payday lending and title lending markets? No scholarship has evaluated head-on the question of whether this concentration is good for consumers. The existing literature on fringe credit markets takes different sides of the debate. Ronald Mann and I argued on theoretical grounds almost ten years ago that large lenders are “both less efficient than the national providers and also more likely to engage in abusive behavior.”⁶ We predicted that an increase in “larger and better-capitalized companies ultimately could lead to better products and prices for the customers in the market.”⁷ On the other hand, more recently, economists Robert DeYoung and Ronnie J. Phillips found that multi-store lenders charged higher prices than independent lenders.⁸ But, despite these casual and narrow discussions, no scholarship looks at the topic in a broader lens or more detailed analysis.

This Article hopes to contribute to the literature on payday and title lending by addressing this simple question: Are bigger payday and title lending companies better for low-income borrowers than smaller companies? To answer this question, I report the results of a study of the advertisements at big and small payday and title lenders’ storefronts in Houston, Texas and these lenders’ websites. More specifically, I compare big and small lenders along several lines: lenders’ compliance with Texas regulations, lenders’ prices, lenders’ use of “teaser rates,” and lenders’ attempts to target minority groups and women.

For each category of evaluation, I explain the argument for what consumer advocates and the anti-payday lending literature consider “good” for

⁴ Mark Furletti, Report from SBREFA Panel on Payday, Title and Installment Loans, CFPB MONITOR (Apr. 30, 2015), available at <http://www.cfpbmonitor.com/2015/04/30/report-from-sbrefa-panel-on-payday-title-and-installment-loans/> (last visited June 30, 2015).

⁵ ARTHUR BAINES ET AL., ECONOMIC IMPACT ON SMALL LENDERS OF THE PAYDAY LENDING RULES UNDER CONSIDERATION BY THE CFPB 8 (May 12, 2015), available at <http://www.cfpbmonitor.com/files/2015/06/Economic-Impact-on-Small-Lenders-of-the-Payday-Lending-Rules-under-Consideration-by-the-CFPB.pdf> (last visited July 15, 2015).

⁶ Ronald J. Mann & Jim Hawkins, *Just Until Payday*, 54 UCLA L. REV. 855, 906 (2007).

⁷ *Id.* at 909.

⁸ Robert DeYoung & Ronnie J. Phillips, *Payday Loan Pricing* 21 (The Fed. Reserve Bank of Kan. City Econ. Research Dep’t, Research Working Paper No. 09-07, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1066761.

consumers. Of course, many of these positions are disputed. For example, some scholars might consider the use of teaser rates to be benign or evidence of a competitive market,⁹ despite consumer advocates' insistence that teaser rates exploit consumers. While some scholars condemn payday and title lenders seeking out female consumers, others might consider the use of pictures of females, for instance, merely to be a legitimate and proven marketing technique that increases loan uptake among men.¹⁰ This Article explicitly does not take a position on those sorts of arguments. Instead, I take as a given that consumer advocates are right for the purposes of the analysis. Thus, really the Article is measuring whether big or small lenders are better for low-income borrowers, according to standards created by opponents of payday and title lending. My goal is not to make a normative argument but instead to make a descriptive contribution based on these preset positions.

Overall, my results are mixed. A higher portion of large companies comply with the law than smaller lenders, but a higher percentage also charges the highest interest rates. Smaller companies are less likely to target racial minority groups in their advertisements, but they are more likely to target women. Roughly similar percentages of small and large companies use teaser rates to bring in customers.

In addition to providing information about the narrow question at the heart of this article, I also present data on industry-wide levels of compliance with the law among payday and title lenders, of pricing information, of the use of teaser rates, and of targeting minorities and women. I find that a significant percentage of payday and title lenders are not complying with Texas's laws requiring certain disclosures on their websites. Also, I observed substantial differences in the prices different lenders charge for loans, and I saw some use of teaser rates to draw in customers. Finally, I found evidence that lenders' advertisements may be targeting minority customers.

This Article was written in conjunction with a symposium on the book *Consumer Credit and the American Economy*,¹¹ which was the inspiration for this research project. In this comprehensive book, one of the many unique contributions the authors make is to focus on the credit products that lower-income Americans use.¹² The authors take seriously the role fringe

⁹ See, e.g., Joshua D. Wright & Douglas H. Ginsburg, *Behavioral Law and Economics: Its Origins, Fatal Flaws, and Implications for Liberty*, 106 NW. U. L. REV. 1033, 1049 (2012) (criticizing behavioral economists for failing to view "teaser rates," zero annual fees, and rewards programs as signs of intense and healthy competition among credit card issuers").

¹⁰ Marianne Bertrand et al., *What's Advertising Content Worth? Evidence From a Consumer Credit Marketing Field Experiment*, 125 Q.J. ECON. 263 (2010) (reporting, based on an experiment in South Africa, that "male clients receiving the female photo took up significantly more, but female clients did not").

¹¹ THOMAS A. DURKIN ET AL., *CONSUMER CREDIT AND THE AMERICAN ECONOMY* (2014).

¹² *Id.* Ch. 8.

lenders play in the current landscape of American credit markets, and I hope this Article contributes to the work that *Consumer Credit and the American Economy* has done to advance the base of knowledge about fringe credit markets. One of the themes concerning regulation in the book that this Article consciously adopts is the risk that regulations will cause unintended consequences.¹³ If we are going to regulate payday and title lending, I argue, we need to know the consequences for the size of firms in the market.

I. METHODOLOGY

To gather data for the study, I used two different strategies, one for analyzing advertisements at physical stores and another for these stores' websites. To ensure that I found all the storefronts operating in Houston, I used the Texas Office of Consumer Credit Commissioner's (OCCC) website's search engine to find all licensed credit access businesses in the city of Houston.¹⁴ Lenders operating in Texas must register with the OCCC,¹⁵ and failing to register is a criminal offense.¹⁶ The Texas OCCC's website creates a spreadsheet with the companies' names and license numbers. An assistant inputted information about the owner and address of each location manually from the Texas OCCC's website.

To obtain information about storefront advertisements, six research assistants visited 189 payday and title lender storefronts between September 14, 2014 and October 30, 2014. They took pictures of every advertisement on the windows of the storefronts and on any signs at the location. They did not take pictures inside the stores. If the research assistant did not feel safe taking photographs at a location, I returned to that address to take pictures.

Using Microsoft Excel, the research assistants typed the text of each advertisement into the spreadsheet. After going through a training session I conducted, they coded the advertisements at each storefront for 17 types of advertisements. I then read through the advertisements in the spreadsheet to check the coding decisions and minimize interrater reliability concerns. I reviewed a substantial portion of the pictures to make sure the text was correctly added to the spreadsheet.

There are 488 storefronts in Houston, and we actually visited 189, or 38.7% of the storefronts. If the company had more than 10 storefronts, I

¹³ See, e.g., *id.* at 447 (describing data about the unintended consequences of Equal Credit Opportunity Act); *id.* at Ch. 5 (describing credit rationing as an unintended effect of interest rate regulation).

¹⁴ TEXAS OFFICE OF CONSUMER CREDIT COMMISSIONER, ADVANCED SEARCH, <https://alecs.occc.texas.gov/Generic/AdvanceSearch?fromSource=true#>.

¹⁵ TEX. FIN. CODE § 393.101.

¹⁶ *Id.* § 393.501.

had research assistants visit a random collection of 10 of the stores. Then, for purposes of reporting information about stores that we did not physically visit, I averaged the information from the 10 stores we photographed and filled in the remainder of the spreadsheet to match those averaged results. It is possible that the 10 stores we visited were not representative of those companies' other stores, so my approach introduces some risk of error. After dropping 25 stores that no longer exist, 463 storefronts remained. 14% of stores (n=65) have 50 or fewer storefronts in Texas, while the remaining 86% (n=398) have more than 50 storefronts.

To obtain information about websites, I used Internet search engines to find websites for the companies on the Texas OCC's list of storefronts. If I could not find a storefront's website, I called the lender and asked for the website's address or verified the lender did not have a website. Thirty of 37 companies have active websites, representing 98.70% (n=457) of the market by storefront.

Many websites advertising payday and title loans are not actually lenders but instead are lead generators.¹⁷ Lead generators obtain information from borrowers and then sell that information to actual lenders, and most Internet loans first begin on these websites.¹⁸ Lead generators are not linked to any specific lender, so they are not useful in this study which compares big and small companies. Thus, I only used the lenders' websites, not lead generator websites. If I was unsure about whether a particular website was the lender's website or a lead generator's website, I called the storefront to ask it for its website address.

After locating websites, research assistants and I recorded 41 pieces of information from the websites, including coding what types of advertisements were present on the websites, testing the websites' compliance with Texas law, recording price information, and noting the race and gender of pictures of customers on the homepage.

Storefront advertisements are an important source of information for some payday loan customers. Some lenders do not advertise at all but instead rely exclusively on drive-by traffic.¹⁹ Moreover, these advertisements outside of lenders are important sources of information because often lenders do not have additional information inside the store for customers to read.²⁰ Similarly, websites are important because 76% of adults who make

¹⁷ PEW CHARITABLE TRUSTS, FRAUD AND ABUSE ONLINE: HARMFUL PRACTICES IN INTERNET PAYDAY LENDING 5 (2014), available at http://www.pewtrusts.org/~media/Assets/2014/10/Payday-Lending-Report/Fraud_and_Abuse_Online_Harmful_Practices_in_Internet_Payday_Lending.pdf.

¹⁸ *Id.*

¹⁹ Nathalie Martin & Ozymandias Adams, *Grand Theft Auto Loans: Repossession and Demographic Realities in Title Lending*, 77 MO. L. REV. 41, 58 (2012) (reporting that ten of the 58 title lending stores involved in their research project were not in the Yellow Pages or on the Internet).

²⁰ Creola Johnson, *Payday Loans: Shrewd Business or Predatory Lending?*, 87 MINN. L. REV. 1, 35 (2002) (reporting that "73% of the payday lenders surveyed during the information-gathering stage did not have brochures about payday loans available for potential customers to peruse").

less than \$30,000 a year use the Internet.²¹ Moreover, consumers take out one third of payday loans over the Internet.²²

There are several limitations to my approach. Most obviously, I only measure large and small companies along a limited number of metrics and based on one type of information, advertisements. I do not, for instance, measure how borrowers' experiences differ at large versus small lenders. Also, because I accept opponents' arguments about what is good for payday and title lending customers without thoroughly examining them, my results only help us understand what is good for low-income customers from that perspective.

Second, I am not claiming the advertisements in Houston are nationally representative. Texas's payday and title lending markets are different from other states in important ways. For example, payday and title lending companies in Texas operate as Credit Service Organizations that locate lenders for borrowers and guarantee borrowers' repayments to the lender.²³ It is not obvious how this business structure affects advertising, but it is possible that it does. In addition, Texas has unique disclosure laws described in the next part that may affect advertisements. Finally, unlike many states, Texas does not have a rate cap on payday and title loans.

II. COMPLYING WITH THE LAW

Probably the least contested measurement of lender behavior is whether the lenders comply with applicable laws and regulations. While people may reasonably disagree about the content of the law, very few will support lenders actively disobeying laws. This Part describes Texas' disclosure laws and my empirical test of lenders' compliance with these laws. I find that a large percentage of lenders in general failed to comply with Texas' laws. More significantly for the topic of this article, large companies were more likely than small companies to comply with the Texas law in all but one category I measured.

A. *Texas's Disclosure Laws*

In 2010, Texas enacted laws that mandated that payday and title lenders, called credit access businesses in the statute,²⁴ post a schedule of all

²¹ PEW INTERNET & AMERICAN LIFE PROJECT, WHO'S ONLINE: INTERNET USER DEMOGRAPHICS, <http://www.pewinternet.org/data-trend/internet-use/latest-stats/>.

²² PEW CHARITABLE TRUSTS, *supra* note 17, at 3.

²³ See Jim Hawkins, *Credit on Wheels*, 69 WASH. & LEE L. REV. 535, 577-78 (2011) (describing Texas's law).

²⁴ TEX. FIN. CODE § 393.221(1).

fees, the name and address of the Texas Office of Consumer Credit Commissioner (OCCC), and a special notice which explains that payday and title loans are only meant to meet short-term cash needs.²⁵ Lenders must post these notices “in a conspicuous location in an area of the business accessible to consumers and on any Internet website, including a social media site, maintained by the credit access business . . .”²⁶ Thus, in order to comply with Texas law, payday and title lender websites should post the three required pieces of information on their websites.

The regulations implementing Texas’ disclosure statute provide additional details about how lenders must operate their websites to comply with the law.²⁷ The rules require that lenders “prominently display” the three Texas notices “in a conspicuous location on the business’s website and on any website where the business advertises to the public.”²⁸ The rules also require that lenders post rate information for the three to five most common loans the lender offers.²⁹ The rule permits the lender to post only links to the fee schedule and the address for the Texas OCCC.³⁰ Additionally, the website must contain these notices “immediately upon the consumer’s arrival at the credit access business’s website that includes information about a payday or auto title loan,”³¹ which I take to mean the website’s homepage.

These administrative rules are unclear, however, about whether the rules only apply to companies that actually offer loans on their websites or whether the rules apply to any credit access business that maintains a website. The uncertainty arises because the rules describe disclosures required for “in person sales”³² and then has a separate provision for “Internet sales” that applies “[f]or business conducted through the Internet.”³³ These rules follow each other, so it appears that the rules for “Internet sales” only apply to those lenders actually lending over the Internet just like the in person disclosures only apply to lenders actually conducting business in person.

Two factors, however, suggest that all lenders with websites must comply with the administrative rules. First, other sections of the Administrative Code seem to mandate the form of the notices in the Finance Code without referencing Internet sales or contrasting Internet and in person sales. For example, the Administrative Code requires that fee schedules that the Finance Code requires of “any Internet website”³⁴ contain three to

²⁵ *Id.* § 393.222(a)(1)-(3).

²⁶ *Id.*

²⁷ *See id.* § 393.222(b) (granting the Finance Commission of Texas authority to adopt rules to implement the disclosure laws).

²⁸ 7 TEX. ADMIN. CODE § 83.6003(b).

²⁹ *Id.* § 83.6004(a).

³⁰ *Id.* § 83.6003(b).

³¹ *Id.* § 83.6007(f).

³² *Id.* § 83.6003(a).

³³ *Id.* § 83.6003(b).

³⁴ TEX. FIN. CODE § 393.222(a).

five examples of common loans.³⁵ Second, in the rule stating that notices about fees must appear on the website's homepage, the Administrative Code applies the rule to any "credit access business's website that includes information about a payday or auto title loan"³⁶ Thus, while the rules create some uncertainty about the extent of the rules' coverage, it appears that the rules apply both to lenders giving loans over the Internet and lenders only giving information about loans.

B. *Testing Lender Compliance*

To assess whether lenders were complying with these disclosure regulations, a trained research assistant viewed the websites for companies operating in Houston to determine if the websites contained (1) the name and address of the Texas OCCC, (2) the notice that the loans are meant to be short-term, (3) any rate schedule, (4) a rate schedule with three to five examples of common loans, and (5) a rate schedule on the website's homepage. Thirty of 37 lenders have active websites, and 11 of those 30 offer loans directly online.

On November 5, 2014, the research assistant viewed all 30 websites from lenders with storefronts in Houston. Table 1 summarizes the findings.

³⁵ 7 TEX. ADMIN. CODE § 83.6004(a).

³⁶ *Id.* § 83.6007(f).

Table 1: Lenders' Compliance with Texas Disclosure Laws and Regulations

Law	Percentage of Websites Complying with Law (n=30) ³⁷	Percentage of Websites Offering Online Loans Complying with Law (n=11)
Name and Address of the Texas OCC	70%	81.8%
Notice that Loans Are Meant to Be Short-Term	73.3%	72.7%
Rate Schedule	80%	100%
Rate Schedule with 3–5 Examples of Common Loans	70%	90.9%
Rate Schedule on Homepage	30%	18.2%

As Table 1 indicates, many lenders did not comply with Texas' laws. In addition to this systematic evaluation, I observed numerous violations of the federal Truth in Lending Act without looking for them. For instance, one website had a chart with different lenders' prices compared to its own, but all of the prices were presented as a dollar amount per hundred dollars borrowed.³⁸ This advertisement appears to violate section 1664(d) of the Truth in Lending Act: "If any advertisement to which this section applies states . . . the dollar amount of any finance charge . . . , then the advertisement shall state . . . [t]he rate of the finance charge expressed as an annual percentage rate."³⁹

Similarly, in a storefront advertisement, a round sign said in moderate sized font, "Title Loans, As Low As," and then in huge font almost the size of the entire sign, it said "8%." In font that was so small it was hard to make out in some of the research assistants' pictures, the sign said: "Annual Percentage Rate ("APR") for Title Loans is based on loan amount, fees, and interest charged and the term." The tiny font then gave an example that had

³⁷ This column includes both the 11 websites that offer loans directly on the Internet that are reported in the next column and the 19 websites that do not offer loans directly through the Internet.

³⁸ Website Observation #28.

³⁹ 15 U.S.C. § 1664(d).

an interest rate of 10% and an APR of 205.64%.⁴⁰ This advertisement seems to violate the regulations implementing the Act because the regulations say an advertisement “shall not state any other rate, except that a simple annual rate or periodic rate that is applied to an unpaid balance may be stated in conjunction with, but not more conspicuously than, the annual percentage rate.”⁴¹

But the mere fact that numerous companies did not comply with state or federal law does not answer the question of whether big or small companies are better at complying. Table 2 summarizes my analysis of large and small lenders on the same five laws introduced above. For all but one of the laws, a larger percentage of large lenders comply than small lenders.

Table 2: Differences in Compliance with Texas Laws

Law	1-50 Stores Complying with the Law (n=19)	More Than 50 Stores Complying with the Law (n=11)
Name and Address of the Texas OCC ⁴²	57.89%**	90.91%**
Notice that Loans Are Meant to Be Short-Term ⁴³	63.16%*	90.91%*
Rate Schedule	73.68%	90.91%
Rate Schedule with 3–5 Examples of Common Loans	63.16%	81.82%
Rate Schedule on Homepage	31.58%	27.27%

⁴⁰ Storefront Observation #203 (and others).

⁴¹ 12 C.F.R. § 226.24(C).

⁴² Large stores are statistically significantly more likely to comply with Texas law requiring that loan stores list the name and address of the Texas OCC than small stores, chi-square(1, N=30) = 3.61, p = 0.057.

⁴³ Large stores are statistically significantly more likely to comply with Texas law requiring that loan stores state that loans are meant to be short term, chi-square(1, N=30) = 2.74, p = 0.098.

*** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$

The fact that large lenders are better at complying with the law is not surprising. Across a variety of industries and legal situations, large companies have proven to be better at absorbing the cost of complying with new laws.⁴⁴ The high, fixed cost of legal of compliance makes up a smaller portion of overall revenue for large companies, so they can devote the necessary resources to compliance.⁴⁵ Moreover, large lenders have more to lose from noncompliance, so they are more likely to spend on compliance.⁴⁶ Numerous statutes exempt small businesses from complying with the statutes, like the Family Medical Leave Act,⁴⁷ demonstrating even the government's recognition the small firms face unique burdens complying with some laws.

Although it is not surprising large lenders are more likely to be in compliance with Texas's disclosure laws, it is surprising that the overall level of compliance among lenders is so low. The laws are relatively

⁴⁴ See, e.g., Tahsen Alqatawni, *The Impact of the Dodd-Frank Act on Small Banks* 4 (Oct. 30, 2013) (unpublished manuscript), available at <http://ssrn.com/abstract=2347812> (“The small banks [were] hit extremely hard by the new [Dodd-Frank Act] regulations, especially the ones without crews of lawyers, lobbyists, and compliance officers.”); Nicholas R. Johnson & A. Bryan Endres, *Small Producers, Big Hurdles: Barriers Facing Producers of “Local Foods,”* 33 *HAMLIN J. PUB. L. & POL’Y* 50, 86 (2012) (explaining that for “[f]armers who wish to turn their raw agricultural commodities into processed items,” the “regulatory costs—and in particular, those designed to make our food safer—can quickly become prohibitive for small producers”); Joseph D. Piotroski & Suraj Srinivasan, *Regulation and Bonding* 33 (Rock Ctr. for Corp. Gov. at Stanford Univ., Working Paper No. 11), available at <http://ssrn.com/abstract=956987> (“Smaller and less profitable firms, along with firms using a low quality auditor, are likely to find the [Sarbanes-Oxley] Act’s costs more onerous.”).

⁴⁵ See Oleg Rezzy, *Sarbanes-Oxley: Progressive Punishment for Regressive Victimization*, 44 *HOUS. L. REV.* 95, 96 (2007) (“It should come as no surprise that smaller companies find it more difficult to comply with section 404 [of the Sarbanes-Oxley Act]. With fewer resources, smaller companies must devote a greater portion of their revenues to finance implementation and compliance expenses. Certainly, larger companies must also finance these expenses, which are much larger than those at smaller firms, but find the costs to be less burdensome than their smaller counterparts.”); Edward A. Morse & Vasant Raval, *Private Ordering in Light of the Law* n.64 (Tilburg Law & Econ. Ctr., Draft 081 210), <http://ssrn.com/abstract=1670112> (citing PONEMON INSTITUTE, 2009 PCIDSS COMPLIANCE SURVEY (2009)) (noting that security compliance in the payment card industry is difficult for small merchants because “high fixed costs make compliance economically difficult for small firms”).

⁴⁶ Mann & Hawkins, *supra* note 6, at 907; Scott Dyreng et al., *Public Pressure and Corporate Tax Behavior*, (Fisher Coll. Of Bus., Working Paper No. 2014-02-003), available at <http://ssrn.com/abstract=2474346> (observing how large companies spent money to comply with tax regulations because “survey reports that 89 percent of the largest respondent firms indicate that they are somewhat or significantly concerned about media coverage of media coverage of firms’ tax activities”) (citing EY, *BRIDGING THE DIVIDE* (2014)).

⁴⁷ David Kwok, *A Fair Competition Theory of the False Claims Act*, 94 *NEB. L. REV.* (forthcoming 2015) (on file with author).

straightforward, so high levels of noncompliance are puzzling and may suggest a need for regulatory involvement.⁴⁸

III. PRICES

The high cost of payday and title loans is probably the most convincing basis for regulating these products.⁴⁹ One common argument against payday lending is “the utter lack of price competition among payday lenders.”⁵⁰ Critics contend that borrowers lack the ability to determine different prices for payday loans⁵¹ and that lenders have formed oligopolies, colluding to charge the highest rate that the law allows.⁵² Opponents argue that lenders compete based on convenience instead of price.⁵³ To offer empirical evidence about this topic, I report general information about price competition in the Houston market.

To assess whether big or small lenders are better for low-income borrowers, I compare the prices they offer in Houston. Following close on the heels of compliance with the law in terms of being uncontroversial, companies offering loans at a low price is not a highly contentious topic. Most scholars think that, all other things being equal, lower prices are better than high ones. Consumer advocates and those opposed to payday and title

⁴⁸ David Adam Friedman, *Reconsidering Fictitious Pricing*, 100 MINN. L. REV. (forthcoming), available at <http://ssrn.com/abstract=2572026> (“Advertising plays a critical role in signaling and market competition. Regulators should be generally reticent to interfere with advertising, correcting every flaw and imperfection. But where a deceptive activity is both common and injurious to welfare, the reticence should be eschewed in favor of vigilance.”).

⁴⁹ Hawkins, *supra* note 23, at 592-93.

⁵⁰ Michael Kenneth, *Payday Lending: Can “Reputable” Banks End Cycles of Debt?*, 42 U.S.F. L. REV. 659, 689 (2008). See also Johnson, *supra* note 20, at 116 (“[D]ue to the lack of competition among payday lenders and due to the industry’s intentional distortion of consumer credit information, economic theory suggests that federal and state lawmakers need to act to regulate the industry.”); DURKIN ET AL., *supra* note 11, at 352 (“Not surprisingly, triple-digit interest rates invite widespread criticism.”).

⁵¹ Kelly J. Noyes, *Get Cash Until Payday! The Payday-Loan Problem in Wisconsin*, 2006 WIS. L. REV. 1627, 1662 (2006) (“Because payday-loan consumers often do not have complete information, most cannot price shop and create price competition. Due to this market failure, increased competition between lenders has failed to lower payday-loan interest rates.”).

⁵² Benjamin D. Faller, *Payday Loan Solutions: Slaying the Hydra (and Keeping It Dead)*, 59 CASE W. RES. L. REV. 125, 139 (2008); Michael Bertics, *Fixing Payday Lending: The Potential of Greater Bank Involvement*, 9 N.C. BANKING INST. 133, 142 (2005); see also Allison S. Woolston, *Neither Borrower Nor Lender Be: The Future of Payday Lending in Arizona*, 52 ARIZ. L. REV. 853, 864 (2010) (“Payday lenders regularly charge the maximum permissible interest in states where the product is allowed.”).

⁵³ Michael A. Garemko III, *Texas’s New Payday Lending Regulations: Effective Debiasing Entails More Than the Right Message*, 17 TEX. J. C.L. & C.R. 211, 220 (2012).

lending repeatedly argue the loans are very costly,⁵⁴ so proof of whether big or small companies offer lower prices offers some evidence of which are better for borrowers.

A. Evidence of Price Competition

In regards to price competition in general, firms in Texas have substantially different prices. After a few hours of looking on lenders' websites, I found the cost of the loan for most lenders in Houston. In Houston, lenders offer payday loans for anywhere from 271% annual percentage rate (APR) to 1151% APR. Companies price title loans from 119% APR to 601%. For all the prices I report, it appears that the loan terms are applicable to any loan in Texas and do not vary based on geographical location. The prices are certainly consistent across the state for lenders offering loans directly over the Internet. It is possible that lenders who do not offer loans directly over the Internet that the lender's website identified my location.⁵⁵ If that is true, a lender might possibly charge different prices throughout the city of Houston. It does not appear, however, that many websites engage in that sorting, so there is a high likelihood the prices I report are consistent throughout Houston.

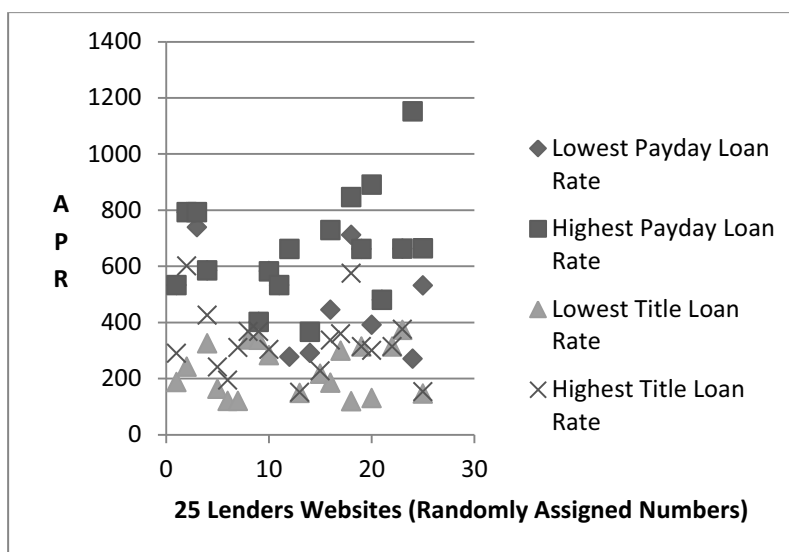
Graph 1 charts the rates I found available on Houston lenders' websites. To find pricing information, I looked at companies' websites to find the price information that Texas law mandates that lenders provide. The websites often state a range of possible prices, often based on the three to five examples that Texas law requires the lenders give.⁵⁶ For each website, I noted the highest and the lowest rate the website contained. For each observation, I report the lowest and highest rate given on the website for each type of loan the lender offers.

⁵⁴ E.g., Nathalie Martin, *Public Opinion and the Limits of State Law: The Case for A Federal Usury Cap*, 34 N. ILL. U. L. REV. 259, 269 (2014); Woolston, *supra* note 52, at 862; Nathalie Martin, *1,000% Interest—Good While Supplies Last: A Study of Payday Loan Practices and Solutions*, 52 ARIZ. L. REV. 563 (2010); Michael A. Satz, *How the Payday Predator Hides Among Us: The Predatory Nature of the Payday Loan Industry and Its Use of Consumer Arbitration to Further Discriminatory Lending Practices*, 20 TEMP. POL. & CIV. RTS. L. REV. 123, 129 (2010); Megan S. Knize, *Payday Lending in Louisiana, Mississippi, and Arkansas: Toward Effective Protections for Borrowers*, 69 LA. L. REV. 317, 335 (2009); Kenneth, *supra* note 50, at 674; Charles A. Bruch, *Taking the Pay Out of Payday Loans: Putting an End to the Usurious and Unconscionable Interest Rates Charged by Payday Lenders*, 69 U. CIN. L. REV. 1257, 1284 (2001).

⁵⁵ One website gave rates by location, but all Houston locations were the same price.

⁵⁶ See *supra* Part II.A.

Graph 1: Price Differentiation in Houston Payday and Title Lending Markets



My ability to easily locate a lot of pricing information and to discover substantially different prices might merely reflect Texas’s disclosure laws and the fact that Texas does not have a rate cap for lenders to gravitate towards, as scholars have argued occurs in jurisdictions with usury caps. But, in Houston at least, lenders charge widely different prices, and consumers who have access to the Internet can find that price information with little effort.⁵⁷

B. Comparing Prices at Small and Large Lenders

To analyze which type of company offers lower prices, I considered the highest and lowest rates on each website as described above. Then, I grouped these rates into two categories—“high” and “low” prices—for purposes of comparing large and small companies. For payday loans, I considered rates above 600% to be “high” and those 600% and below to be “low,” relatively speaking.⁵⁸ For title loans, I deemed rates above 250% to be higher and those 250% and below to be lower.

⁵⁷ Of course, lenders might post inaccurate or misleading rate information on websites, so the prices I report may be different from the rates given to customers at the actual storefronts.

⁵⁸ To classify some rates as high and others as low, I tried to find a rough midpoint that would result in half the lenders’ prices falling above and below the threshold.

Tables 3 and 4 summarize the results of my analysis. In every category except the lowest title loan rate on the website, a higher percentage of larger lenders had higher rates than smaller lenders, although one difference did not meet the test for statistical significance. These Tables do not specify how far from 600% or 250% lenders' rates were, but as Graph 1 depicts, the rates range greatly and are not clustered near to 600% and 250%.

Table 3: Differences in Payday Loans Prices

Type	Percentage of 1-50 Stores with Rates Above 600% (n=37) ⁵⁹	Percentage of Storefronts More Than 50 Stores Rates Above 600% (n=297) ⁶⁰
Lowest Payday Loan Rates Listed on the Website ⁶¹	10.81%***	58.59%***
Highest Payday Loan Rates Listed on the Website ⁶²	45.95%***	66.67%***

*** p<0.01, ** p<0.05, * p<0.1

⁵⁹ This number is 37 instead of 65 (the number of small storefronts) because I could only find rate information for a portion of the market and some lenders do not offer payday loans.

⁶⁰ This number is 297 instead of 398 (the number of large storefronts) because I could only find rate information for a portion of the market and some lenders do not offer payday loans.

⁶¹ This difference is statistically significant $\chi^2(1 N=334) = 30.16, p = 0.000$.

⁶² This difference is statistically significant $\chi^2(1 N=335) = 6.16, p = 0.013$.

Table 4: Differences in Title Loans Prices

Type	Percentage of 1-50 Stores with Rates Above 250% (n=43) ⁶³	Percentage of Storefronts More Than 50 Stores Rates Above 250% (n=315) ⁶⁴
Lowest Title Loan Rates Listed on the Website ⁶⁵	48.84%***	20.32%***
Highest Title Loan Rates Listed on the Website	76.74%	83.81%

*** p<0.01, ** p<0.05, * p<0.1

The high cost of payday and title loans is central to popular and academic discussion of why these loans are detrimental to borrowers. The fact that smaller lenders are more likely to have relatively lower rates is significant.⁶⁶ It is also counterintuitive. Larger lenders should be able to charge less—they benefit from economies of scale,⁶⁷ their cost of obtaining credit should be lower,⁶⁸ and they should be able to work off lower margins.⁶⁹ The rates are higher at larger companies might merely reflect willingness on the part of these firms to extend more risky loans, but this explanation seems unlikely to be true because there is no evidence of it in existing literature on

⁶³ This number is 43 instead of 65 (the number of small storefronts) because I could only find rate information for a portion of the market and some lenders do not offer title loans.

⁶⁴ This number is 315 instead of 398 (the number of large storefronts) because I could only find rate information for a portion of the market and some lenders do not offer title loans.

⁶⁵ This difference is statistically significant $\chi^2(1 N=358) = 16.99, p = 0.000$.

⁶⁶ Note that my findings are in line with DeYoung & Phillips, *supra* note 8.

⁶⁷ Cf. Lauren E. Willis, *Will the Mortgage Market Correct? How Households and Communities Would Fare If Risk Were Priced Well*, 41 CONN. L. REV. 1177, 1217 (2009) (“Due to economies of scale, large servicers can service loans at lower cost than small servicers.”).

⁶⁸ See Michael F. Spivey & Jeffery F.J. McMillan, *Value Creation and the Entrepreneurial Business*, J. ENTREPRENEURIAL FIN. & BUS. VENTURES, Apr. 2002, at 23, 25 (“Small businesses have fewer options for financing, as access to public markets is fairly expensive. Large companies can more easily cover these fixed costs than can small businesses. In addition, small businesses have much greater difficulty obtaining debt financing than large companies.”).

⁶⁹ Cf. Dean C. Minderman, *Open House*, CREDIT UNION MANAGEMENT, 47 (1994) (“Formerly known as City Credit Union, SFCU serves 23,000 members, including city employees and workers at more than 170 select employee groups. In the major Seattle market, the credit union can’t compete on rate with larger lenders that can work off a smaller margin; hence, the emphasis on service.”).

payday lending nor do larger firms advertise their willingness to take bigger risks. The fact that larger lenders are charging more and not less for payday and title loans is curious and troubling as we enter an era where regulatory invention will support large lenders without simultaneously capping interest rates.⁷⁰

IV. TEASER RATES

This Part reports findings about the general use of “teaser rates” among payday and title lenders in Houston and compares the use of these rates between large and small lenders. I find that firms do use teaser rates to draw in customers and that roughly the same percentages of large and small companies advertise these rates.

A common criticism of consumer credit products in general is that they exploit borrowers’ tendencies to be overly optimistic.⁷¹ This concern is especially common among opponents of payday loans.⁷² One way that critics say that lenders take advantage of overly optimistic borrowers is by offering a low introductory rate, a “teaser rate,” for a credit product and then increasing the rate in the future. Borrowers, the thinking goes, will take out the product because of the low rate and their belief that they will not have to pay the higher future rate since “by then I will make more money and will have paid off my credit card” or the like.⁷³

For payday and title lending borrowers, we could imagine that people are overly optimistic about how quickly they will pay off their loans. People might optimistically think they will pay off the loan after the first two-week or one-month period, only to later learn it would take five loan peri-

⁷⁰ See 12 U.S.C. § 5517 (“No provision of this title shall be construed as conferring authority on the Bureau to establish a usury limit applicable to an extension of credit offered or made by a covered person to a consumer, unless explicitly authorized by law.”).

⁷¹ For just two examples, see Cass R. Sunstein, *Boundedly Rational Borrowing*, 73 U. CHI. L. REV. 249 (2006); Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373 (2004).

⁷² See, e.g., Olivia M. Peña, *Municipal Regulation of Payday & Title Loans in Texas an Exemplary & Constitutional Good for A Necessary & Predatory Evil*, 17 J. CONSUMER & COM. L. 71, 76 (2014) (“Lenders promote the beneficial side of payday and title loans because they are aware of consumers’ over optimism.”); Alan M. White, *Behavior and Contract*, 27 LAW & INEQ. 135, 159 (2009) (“Payday loans, for example, are described (falsely) as a short-term credit product, exploiting the consumer’s optimism bias that predicts an ability to pay the loan in full at the next payday, and discounts the inevitable recurrence of the cash shortage that prompted the loan.”). *But see* Ronald J. Mann, *Assessing the Optimism of Payday Loan Borrowers*, 22 SUP. CT. ECON. REV. 105 (2014) (finding borrowers are reasonably good at predicting their own future repayment speed); Kathryn Fritzdixon *et al.*, *Dude, Where’s My Car Title?: The Law, Behavior, and Economics of Title Lending Markets*, 2014 U. ILL. L. REV. 1013 (2014) (finding only weak evidence of overoptimism among title lending borrowers); Jim Hawkins, *The Federal Government in the Fringe Economy*, 15 CHAP. L. REV. 23, 68 (2011) (“[D]irect evidence of over optimism in payday lending markets simply does not exist at this point.”).

⁷³ Bar-Gill, *supra* note 71, 1375-76.

ods to completely pay off the loan. If they underestimate the amount of time it will take to pay off their loans, borrowers will underestimate the true cost of the loan.⁷⁴ An opportunistic lender could try to draw in customers by offering the borrower a first loan at a discounted rate, hoping that the borrower will underestimate the likelihood of needing more than that first time period to completely pay off the loan. Indeed, the Federal Trade Commission recently went after a lender for using a deceptive introductory rate.⁷⁵

Some firms in the Houston market advertise teaser rates, which are arguably aimed at exploiting the over-optimism bias. These advertisements said things like “Title Loans Free for 30 Days” or “Up To \$500 Off First Loan.” Overall, 17.72% of websites had advertisements with teaser rates, and 15.80% of storefronts had advertisements with teaser rates.

In terms of comparing how likely large versus small lenders were to advertise teaser rates, the results were mixed. As Table 5 summarizes, a larger percentage of large companies had teaser rates in storefront advertisements than smaller companies. But, a larger portion of small companies had teaser rate advertisements on their websites. Thus, on this measure, large and small lenders appear to act in substantially similar ways, all things considered.

⁷⁴ Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PENN. L. REV. 101, 112 (2008).

⁷⁵ Krystal Steinmetz, *Feds Target Auto Title Lenders for Deceptive ‘Zero Percent’ Loans*, MONEY TALKS NEWS (Feb. 2, 2015), available at <http://www.moneytalksnews.com/feds-target-auto-title-lenders-for-deceptive-zero-percent-loans> (“The FTC alleges that Finance Select, which operated as Fast Cash Title Pawn, didn’t tell borrowers that the loan had to be paid in 30 days or the zero percent offer was null and void, leaving the borrower to pay a finance charge. Again the car title lender did not disclose the amount of the finance charge.”).

Table 5: Differences in Advertisements Containing Teaser Rates

	1-50 Stores (n=65 for store- fronts; n=59 for websites)	More Than 50 Stores (n=398 for store- fronts and for web- sites)
Percentage of Store- fronts with Teaser Rate Advertisements	9.23%	16.83%
Percentage of Web- sites with Teaser Rate Advertisements ⁷⁶	44.07%***	13.82%***

*** p<0.01, ** p<0.05, * p<0.1

The fact that these measures cut both ways suggests the need for further analysis. In future work using this same data, I intend to measure more carefully the extent to which payday and title lenders use advertising to present information we would predict a rational actor would require in making a lending decision versus to exploit well-known behavioral biases.

V. RACE AND GENDER

A consistent concern among opponents of payday loans is that these loans target minority communities and women.⁷⁷ The Chairwoman of the

⁷⁶ This difference is statistically significant $\chi^2(1 N=457) = 32.24, p = 0.000$.

⁷⁷ See, e.g., Linda R. Crane, *Checking Out of the Exception to 3-104: Why Parties Should Be Able to Negotiate Whether Checks Should Be Payable on Demand*, 3 COLUM. J. RACE & L. 73, 88 (2013) (“Even more troubling is the fact that payday loan customers are disproportionately drawn from politically and economically disadvantaged groups: racial minorities, women and military families who are deliberately targeted by payday loan operators.”); Satz, *supra* note 54, at 138 (“Studies overwhelming indicate, however, that the payday lenders do target minority consumers, and in particular those with African American and Hispanic backgrounds.”); Paulina E. Davis, *Racism, Capitalism, and Predatory Lending: How the U.S. Government’s Failure to Regulate the Disproportionate Negative Effects of Payday Lending in Black Communities Violates the International Convention on the Elimination of All Forms of Racial Discrimination*, 4 HUM. RTS. & GLOBALIZATION L. REV. 61, 62 (2011) (“Congress should enact legislation that protects Black communities from payday lending practices, which as will be discussed, have a disproportionate negative economic impact on Black communities as compared to White communities.”); Richard J. Thomas, *Rolling over Borrowers: Preventing Excessive Refinancing and Other Necessary Changes in the Payday Loan Industry*, 48 WM. & MARY L. REV. 2401, 2403

Congressional Hispanic Caucus and the Chairman of the Congressional Black Caucus recently wrote to CFPB Director Richard Cordray, “What is particularly concerning is that payday lenders target low-income communities and communities of color.”⁷⁸ Much of the academic work⁷⁹ and consumer advocacy work⁸⁰ on this topic focuses on where payday lending stores are located as a proxy for targeting minority groups, although studies on geography as well as other measures of targeting minorities reach different results on this question.⁸¹

Several important legal academic articles argue that lenders target minorities and women. First, Creola Johnson explains different ways lenders target racial minorities through advertising:

These lenders attract minority borrowers through the use of minority celebrities and community leaders because many of these prospective borrowers are more likely to obtain a predatory loan when it is marketed by someone considered trustworthy in their communities. . . . In addition to using prominent minorities as spokespersons in advertising, lenders have retained minority employees for the purpose of establishing trust with potential minority borrowers. Lenders even sponsor minority events and target minority churches to recruit customers. In short, to peddle predatory loans to minorities, lending companies have exploited the affinity that many minorities feel for others in their community.⁸²

(2007) (“One of the reasons most frequently offered to justify regulation of the payday loan industry is that it preys on minorities, women, and those who are poor or uneducated.”). *But see*, Donald P. Morgan & Kevin J. Pan, Do Payday Lenders Target Minorities?, <http://libertystreeteconomics.newyorkfed.org/2012/02/do-payday-lenders-target-minorities.html#.VZP1DPIVikp> (“[O]nce we control for financial characteristics—such as past delinquency, debt-to-income ratios, and credit availability, blacks and Hispanics are not significantly more likely than whites to use payday credit.”).

⁷⁸ Keith Ellison et al., Opinion Letter to Richard Cordray, Mar. 4, 2015, <http://www.cfpbmonitor.com/files/2015/03/Caucus-letter.pdf>.

⁷⁹ Robin A. Prager, *Determinants of the Locations of Payday Lenders, Pawnshops and Check-Cashing Outlets*, 11 – 13 (Federal Reserve Board of Governors Finance and Economic Discussion, Working paper 2009 33, 2009), at <http://www.federalreserve.gov/pubs/feds/2009/200933/200933paper.pdf> (summarizing five research papers that use payday store location as a proxy for racial targeting).

⁸⁰ Wei Li et al., *Predatory Profiling: The Role of Race and Ethnicity in the Locations of Payday Lenders in California*, Center for Responsible Lending 2 (2009), at <http://www.responsiblelending.org/california/ca-payday/research-analysis/predatory-profiling.pdf> (“Even after controlling for income and a variety of other factors, payday lenders are 2.4 times more concentrated in African American and Latino communities.”).

⁸¹ Neil Bhutta, *Payday Loans and Consumer Financial Health*, (Federal Reserve Board of Governors Finance and Economic Discussion, Working paper 2013-81, 2013), at <http://www.federalreserve.gov/pubs/feds/2013/201381/201381pap.pdf> (“Interestingly, the analysis of payday lender locations does not indicate that lenders target minority neighborhoods, conditional on economic characteristics of the population. This result is important in its own right because of fair lending concerns that payday lenders target minority neighborhoods without economic justification.”).

⁸² Creola Johnson, *The Magic of Group Identity: How Predatory Lenders Use Minorities to Target Communities of Color*, 17 GEO. J. ON POVERTY L. & POL’Y 165, 172-73 (2010).

As this passage illustrates, Johnson emphasizes the connection lenders make with minority communities through having minorities involved on the lenders' side of the transaction.

In terms of marketing to women, Amy Schmitz summarizes evidence from a variety of sources that found that women are over represented among payday lending borrowers.⁸³ She theorizes that disproportionate use may result from women having lower wages and women having fewer other alternatives.⁸⁴ Significant for the purposes of this article, she also asserts that more women may use payday loans because lenders steer them towards payday loans by using images of females. She offers one example: "CashOne's website showcases a female payday loan representative smiling above the 'member login' box, which may lure women who seek familiarity of working with another woman."⁸⁵

My study of payday and title lending advertisements offers new evidence in these debates because it is based on a different source of information than geography or actual customer demographic information. Arguably, we can see who lenders are targeting most clearly by the advertisements lenders are using to target people.

To obtain this information about advertisements on this issue, we took two steps. First, part of the coding work for storefront advertisements was evaluating if lenders targeted racial minorities through storefront advertisements. We looked for the types of advertising that Johnson describes—minority celebrities or other references to minority cultures. In addition, we looked for advertisements in different languages. For the most part, the advertisements we coded as targeting minorities were advertisements in Spanish, which we coded as targeting Hispanics.

Second, using the websites located through the Texas' OCCC's list of lenders in Houston, I and two other research assistants attempted to record the races and genders of the pictures of customers on these websites. To mitigate the possibility of our own race/gender skewing the results, I had two women and one man do the coding, including one White person, one Black person, and one Hispanic person. We all followed the same protocol. We only considered the races and genders of people appearing to be customers, as opposed to employees or owners; we only considered people pictured on the website's homepage; and we counted the picture even if it is only a partial picture or the picture was partially obscured. For each customer depicted, we categorized the customer as male or female and as White, Black, Hispanic, Asian, or unable to determine race. If we disagreed about the race of a customer, I reevaluated the website, most often going with the view of the majority. Of course, we did not verify the actual

⁸³ Schmitz, *supra* note 3, at 74-80.

⁸⁴ *Id.* at 78-80.

⁸⁵ *Id.* at 84.

race of any of the people pictured in advertisements. I only report our impressions here.

My theory behind using the race of customers featured on lender websites uses Johnson's suggestion that lenders use racial minorities in their advertisements to appeal to other racial minorities from the same racial group. Social psychologists tell us that we follow the lead of people we perceive to be like ourselves.⁸⁶ If lenders feature racial minorities in their advertising, then we have some evidence that they are targeting minorities.

Table 6 summarizes the aggregate data about the industry in general from the study. They suggest that many payday and title lenders are in fact targeting minorities in their advertisements through both their storefronts and websites. The number of pictures of women and minorities outpaces the general population of Texas for both of these groups, and it even outnumbers the actual users of payday and title lending products.

⁸⁶ ROBERT B. CIALDINI, *INFLUENCE: THE PSYCHOLOGY OF PERSUASION* 140 (2007) ("It is the conduct of such people that gives us the greatest insight into what constitutes correct behavior for ourselves. Therefore we are more inclined to follow the lead of a similar individual than a dissimilar one.").

Table 6: Pictures of Females and Racial Minorities on Websites

	Per-centage in Texas Popu-lation ⁸⁷	Per-centage of Auto Title Lending Customers ⁸⁸	Per-centage of Payday Lending Customers ⁸⁹	Num-ber of Pic-tures on Web-sites ⁹⁰	Per-centage of Actual Pic-tures on Web-sites	Per-centage of Pic-tures in Total Houston Market by Store-front
Male	49.6%	41.6%	48%	30	40%	37.2%
Female	50.4%	58.4%	52%	45	60%	62.8%
White	42.7%	57.8%	55%	24	36.4%	34.2%
Hispanic	28.6%	17.8%	14%	23	28.8%	34.0%
Black	20.4%	15.6%	23%	23	34.8%	31.8%
Asian	1.4%	0.7%	6% (other)	0	0	0

In terms of the aggregate storefront data, I found that 77.3% (n=357) of storefronts had advertisements aimed at minorities. Virtually all of these advertisements were standard advertisements that were just in Spanish.

Tables 7 and 8 compare how likely large lenders and small lenders are to target women and racial minorities. Large companies are more likely to have storefront advertisements aimed at racial minorities than small companies at a statistically significant level, and large companies are more likely to have websites dominated by pictures of racial minorities. On the other hand, a higher percentage of small lenders have more pictures of women than men on their websites.

⁸⁷ U.S. CENSUS BUREAU. AMERICAN FACT FINDER, TEXAS UNITED STATES CENSUS BUREAU, <http://factfinder.census.gov/faces/nav/jsf/pages/index.xhtml> (insert “Texas” into the “Community Facts” search box, and select “Go”) (last visited Mar. 8, 2015).

⁸⁸ Fritzdixon et al., *supra* note 72, at 1029.

⁸⁹ PEW CHARITABLE TRUSTS, PAYDAY LENDING IN AMERICA: WHO BORROWS, WHERE THEY BORROW, AND WHY 35 (2012), http://www.pewtrusts.org/~media/legacy/uploadedfiles/pcs_assets/2012/PewPaydayLendingReportpdf.pdf.

⁹⁰ For 8 pictures, we were unable to determine or come to a consensus on the race of the person in the picture.

Table 7: Differences in Storefronts Targeting Racial Minorities

	1-50 Stores (n=65)	More Than 50 Stores (n=398)
Percentage of Storefront Advertisements Targeting Minority Groups ⁹¹	35.38%***	84.17%***

*** p<0.01, ** p<0.05, * p<0.1

Table 8: Differences in Percentages of Website Pictures Being Predominately Women and Racial Minorities

	1-50 Stores (n=48)⁹²	More Than 50 Stores (n=386)⁹³
Percentage of Websites with More Pictures of Women than Men ⁹⁴	85.42%***	60.62%***
Percentage of Websites with More Pictures of Minorities than Whites ⁹⁵	38.98%***	68.65%***

*** p<0.01, ** p<0.05, * p<0.1

Unlike geographic locations of lenders, which may be explained by demand or economic conditions, there is not an obvious explanation for

⁹¹ This difference is statistically significant $\chi^2(1 N=463) = 75.84, p = 0.000$.

⁹² This number is 48 instead of 65 (the number of small storefronts) because I did not consider storefronts without websites or websites without pictures in this analysis.

⁹³ This number is 386 instead of 398 because I did not consider websites without pictures in this analysis.

⁹⁴ This difference is statistically significant $\chi^2(1 N=434) = 11.31, p = 0.001$

⁹⁵ This difference is statistically significant $\chi^2(1 N=434) = 8.22, p = 0.004$.

why lenders would use more pictures of minorities in their advertising than the actual number of minorities who use the lending products. Fortunately, if lenders are not intending to target minority groups, it is also something lenders could easily remedy by being mindful of how they are presenting their products. In the absence of change, however, my data suggest that currently large lenders are more likely than smaller lenders to have advertisements aimed at drawing in customers that belong to minority groups.

CONCLUSION

As state and federal governments consider laws and regulations for payday and title lending, they should account for the ways that laws can change the size of participants in these credit markets for the poor. This Article has shown that large lenders, although more likely to comply with new regulations, are more likely to charge higher interest rates for loans and more likely to use their advertising to target members of minority groups. While more research is needed to understand the different experiences and outcomes borrowers have with large and small lending organizations, these findings suggest a need to proceed cautiously before intervening in the market in a way that will cause small lenders to close their doors.

THE SOCIAL COSTS OF CREDIT REPORTING ERRORS

*Richard Hynes**

INTRODUCTION

Congress enacted the Fair Credit Reporting Act (the “FCRA”)¹ to ensure the accuracy of credit reports.² The FCRA has been in effect for nearly forty-five years,³ but a recently completed Federal Trade Commission study estimates that about twenty percent of credit reports still contain “material errors.”⁴ Credit report errors can impose significant costs on the consumers who are the subjects of the flawed reports as a bad credit report can impair a consumer’s access to credit, insurance, housing, and employment.⁵

This essay argues that the social costs of a credit report error are likely to be substantially less than the private costs that the consumer suffers. A mistake harms a consumer by making her appear to be a greater risk than she really is; she is forced to “pool” with higher-risk or otherwise less desirable consumers. But the consumer’s presence in the higher-risk pool will lower the average risk in that pool and thus provide offsetting benefits to the truly high-risk consumers. If we ignore complicating factors such as misallocation, moral hazard, adverse selection, and alternative screening and signaling devices, the low-risk victim’s loss is precisely offset by the

* Nicholas E. Chimicles Research Professor in Business Law and Regulation, University of Virginia School of Law. I would like to thank Bob Hunt and workshop participants at the George Mason and University of Virginia schools of law for suggestions and corrections.

¹ 15 U.S.C. §§ 1681-1681x.

² See *id.* § 1681(b); 114 CONG. REC. 24,902 (1968) (Senator Proxmire stating that the legislation should address cases where a “consumer is unjustly denied credit because of faults or incomplete information in a credit report, or because he has been confused with another individual.”); See NATIONAL CONSUMER LAW CENTER, FAIR CREDIT REPORTING 11-26 (8th ed. 2013) for a review of the legislative history of the FCRA.

³ The FCRA took effect on April 25, 1971. See NATIONAL CONSUMER LAW CENTER, *supra* note 2, at 6.

⁴ FEDERAL TRADE COMMISSION, REPORT TO CONGRESS UNDER SECTION 319 OF THE FAIR AND ACCURATE CREDIT TRANSACTIONS ACT OF 2003 (2012), available at <http://www.ftc.gov/sites/default/files/documents/reports/section-319-fair-and-accurate-credit-transactions-act-2003-fifth-interim-federal-trade-commission/130211factareport.pdf> [hereinafter FTC Report].

⁵ See 15 U.S.C. § 1681b (listing permitted uses of credit reports); Chi Chi Wu, *Automated Injustice: How A Mechanized Dispute System Frustrates Consumers Seeking to Fix Errors in Their Credit Reports*, 14 N.C. BANKING INST. 139 (2010); Michael R. Guerrero, *Disputing the Dispute Process: Questioning the Fairness of S1681s-2(a)(8) and S1681j(a)(1)(a) of the Fair and Accurate Credit Reporting Act*, 47 CAL. W. L. REV. 437 (2011) (“He who has lost his credit is dead to the world.”).

high-risk consumers' gain, and the credit reporting mistake creates no social costs.⁶

The claim that credit report errors may impose no or low social costs is consistent with arguments commonly made in insurance and other risk-classification contexts. In this essay I demonstrate that, as a theoretical matter, the effect of a misstatement in a credit report is roughly equivalent to any other imperfection in a risk-classification mechanism such as an imperfect proxy used by an automobile and health insurer.⁷ The law sometimes mandates these imperfections. For example, federal law limits the ability of a health insurer to charge more to consumers with pre-existing conditions (higher-risk consumers),⁸ and the FCRA itself prohibits credit bureaus from reporting some negative information about consumers.⁹ Although the mistakes created by FCRA's gag rule are mistakes of omission rather than commission, they have the same basic effect as a misstatement in a credit report. These mistakes make it harder for low-risk consumers to separate themselves from high-risk consumers.¹⁰

This essay does not claim that credit report errors have no social costs because the assumptions underlying that result are not realistic. The low-risk types may respond to the increased price that they must pay for credit or insurance by leaving the market so that only the high-risk consumers remain; mistakes can create adverse selection. Mistakes can also cause misallocation because the lower price faced by the higher-risk consumers may cause them to buy a credit or insurance product even though their willingness to pay does not exceed the cost of providing the product to them. Forced pooling lowers the reward consumers receive for investments that lower their risk, creating a form of moral hazard. Finally, firms may look for other ways to screen high-risk consumers, and low-risk consumers may look for costly ways to signal their type. The most salient example of this alternative signaling behavior is that some consumers spend considerable time and effort correcting the mistakes in their credit files.¹¹

Other risk-classification imperfections can also impose social costs for the very same reasons. For example, FCRA's gag rule can create misallo-

⁶ See *infra* Section II.A.

⁷ See *infra* Section III.A.

⁸ See 42 U.S.C. § 300gg (2012) (requiring health insurers for individuals or small group markets to vary premiums based only on several factors other than preexisting health conditions). See also 29 U.S.C. § 1182(b) (2012) & 42 U.S.C. § 300gg-4(b) (prohibiting group health plans from requiring individuals to pay higher premiums based on preexisting health conditions).

⁹ See 15 U.S.C. § 1681c (prohibiting the reporting of negative information that is old unless certain exemptions apply).

¹⁰ See *infra* Section III.B.

¹¹ See, e.g., Julia Cheney et al., Consumer Use of Fraud Alerts and Credit Freezes: An Empirical Analysis, Federal Reserve Working Paper (2014), available at <http://www.philadelphiafed.org/consumer-credit-and-payments/payment-cards-center/publications/discussion-papers/2014/D-2014-IdentityTheft.pdf>.

cation and adverse selection by lowering the cost of credit for high-risk consumers and raising the cost of credit for low-risk consumers. To the extent that this gag rule reduces the penalty that a consumer suffers from default, it can create a form of moral hazard. This gag rule can also cause lenders and low-risk consumers to turn to costly screening devices such as the use of collateral.

As a theoretical matter, imperfections in risk-classification do not necessarily impose social costs; indeed they may confer social benefits. To take one example, insurance scholars sometimes justify limits on risk-classification by arguing that these limits may reduce the price that consumers pay, on average, because the insurers would otherwise have to recover the costs of risk-categorization.¹² Other scholars try to justify FCRA's limit on reporting negative information by suggesting that this law may mitigate a moral hazard faced by high-risk consumers by allowing them to pool with low-risk consumers.¹³ Each of these arguments can be adapted to suggest that credit report errors—or a lack of care that causes credit-report errors—can increase social welfare.¹⁴

I do not claim that there is no difference between a credit report error and a law that limits what can be placed in a credit report, and I am not arguing that the FCRA should be changed. A normative analysis of the regulation of credit reporting must account for distributional consequences as well as the incentives of the industry participants to produce accurate reports. These tasks are left to future work; this essay merely tries to take the first step along the path.

Part I of this essay provides an overview of credit reporting, its regulation, and the nature and frequency of credit report errors. Part II begins by demonstrating that the social costs of credit report errors are zero if strong assumptions are true. Part II then goes on to relax these simplifying assumptions and acknowledge that credit report errors can create significant social costs. Part III establishes the parallel between credit report errors and other risk-classification imperfections such as laws that limit the information that credit bureaus can report. Part IV concludes.

¹² See, e.g., Ronen Avraham et al., *Understanding Insurance Antidiscrimination Law*, 87 S. CAL. L. REV. 195, 208-09 (2014).

¹³ See Ronel Elul & Piero Gottardi, *Bankruptcy: Is It Enough to Forgive or Must We Also Forget*, Federal Reserve Working Paper 2011, available at <http://www.philadelphiafed.org/research-and-data/publications/working-papers/2011/wp11-14.pdf>.

¹⁴ See *infra* Section III.

I. CREDIT REPORTING AND ITS REGULATION

Part A provides a brief overview of the credit reporting industry and the nature of credit report errors. Part B describes the current and proposed regulation of the industry.

A. *An Overview of the Credit Reporting Industry*

The credit reporting industry began as a series of largely regional co-operatives among retailers who shared information about their customers.¹⁵ However, the industry is now dominated by three national credit bureaus whose reports are used by a wide variety of entities including creditors, insurers, employers, and landlords.¹⁶

This essay focuses on the reports produced by the three major credit bureaus, but the scope of the FCRA is much broader—it regulates “consumer reports” issued by “consumer reporting agencies.”¹⁷ A consumer report is almost any report about a consumer that is used for credit, insurance, employment, housing, or similar purposes.¹⁸ The FCRA therefore covers specialized consumer reports such as those produced by insurers to share information on insured events, those produced by landlords to report on tenant behavior; those used by payday lenders to report the credit history of their borrowers, and may even cover college placement offices.¹⁹ There is a very important exception—the FCRA does not apply if the speaker is drawing solely on its own experience with the consumer.²⁰ The FCRA therefore does not regulate a reference given by an employer, but it does regulate background checks conducted by outside firms unless some other exemption applies.²¹

Some consumer reports contain qualitative information such as summaries of interviews with a consumer’s co-workers and neighbors.²² How-

¹⁵ The existing literature offers several excellent overviews of the credit reporting industry as well as its history and regulation. *See, e.g.*, CFPB, Key Dimensions and Processes in the U.S. Credit Reporting System (12/2012), Robert M. Hunt, A Century of Consumer Credit Reporting in America, Federal Reserve Bank Working Paper (2005), Avery et al., Credit Reporting and Access to Credit, Federal Reserve Bulletin, 2004; Mark Furletti, An Overview and History of Credit Reporting (2002), FTC, 40 Years of Experience with the Fair Credit Reporting Act (2011).

¹⁶ *See* NATIONAL CONSUMER LAW CENTER, *supra* note 2, at 4-5.

¹⁷ 15 U.S.C. § 1681a.

¹⁸ *Id.* § 1681a(d)(1).

¹⁹ *See* NATIONAL CONSUMER LAW CENTER, *supra* note 2, at 71-

75. The CFPB maintains a list of some of these consumer reporting agencies at http://files.consumerfinance.gov/f/201207_cfpb_list_consumer-reporting-agencies.pdf.

²⁰ 15 U.S.C. § 1681a(d)(2)(A)(i).

²¹ *See* NATIONAL CONSUMER LAW CENTER, *supra* note 2, at 51-52, 54-56, 71-75.

²² *Id.* at 56.

ever, this essay does not focus on these “investigative consumer reports.”²³ The credit reports produced by the major credit bureaus contain little if any qualitative data, focusing instead on more objective criteria such as the number and amount of debts outstanding and the debtor’s past payment history.²⁴ The credit bureaus gather most of the information from creditors who purchase reports from them, but they also gather data from public records (*e.g.*, bankruptcy filings, judgment liens, etc.).²⁵ The FCRA refers to those who provide information to the consumer reporting agencies as furnishers²⁶ and to those who use consumer reports as users.²⁷ I will use these same terms, but it is important to remember that furnishers and users are often the same entities. For example, if a bank obtains a consumer report in connection with a loan application, it is a user. If it grants the loan and subsequently reports the consumer’s payment history, it is a furnisher.

Errors can arise at any many points in the credit reporting process.²⁸ A consumer could make a mistake when filling out a loan application, or a furnisher could misread the consumer’s information, and the mistake could be transmitted to the credit bureau. A furnisher could wrongly report that a consumer has defaulted on her obligation when she has in fact paid, or the furnisher could misidentify the consumer who has defaulted. Some mistakes may not be innocent. For example, credit repair organizations sometimes report fictitious obligations and repayment histories in order to boost a consumer’s credit score.²⁹ The credit bureaus try to maintain some quality by conducting initial and periodic audits of their furnishers,³⁰ but such quality controls will never be perfect.

The credit bureaus receive data from a very large number of furnishers, and they make mistakes as they try to match this information to the files that they maintain on each consumer. Assume that I receive medical care while attending a conference in Cambridge, Massachusetts, but I do not pay the bill. If a credit bureau were careless, it might attribute my default to the much more eminent Professor Richard Hynes, Richard O. Hynes, the biologist from the Massachusetts Institute of Technology.³¹ The credit bureau might be able to avoid this mistake by omitting the reported default from his file unless the hospital’s report matched his file along several dimensions such as full name (including middle name or initial), social security number, home address, etc. However, the information that credit bureaus receive from furnishers may not always be complete, and furnish-

²³ 15 U.S.C. § 1681a(e).

²⁴ See NATIONAL CONSUMER LAW CENTER, *supra* note 2, at 71-75.

²⁵ *Id.* at 4-5; CFPB, *supra* note 15, at 8-10.

²⁶ 15 U.S.C. § 1681s-2.

²⁷ *Id.* § 1681m.

²⁸ See CFPB, *supra* note 15, at 24-25.

²⁹ See *id.* at 18.

³⁰ *Id.* at 18-19.

³¹ Richard O. Hynes, Principal Investigator at <http://hynes-lab.mit.edu>.

ers will sometimes make mistakes.³² Assume, for example, that the credit bureau receives a report of a default by a Richard O. Hynes but the reported default matches the information in my file along in all other conceivable ways (same home address, social security number, etc.). Should the credit bureau include the information in my file? If they include the information they risk one type of error—wrongly including incorrect information in my file. But if they omit the default they risk another type of error—wrongly excluding correct information from my file.

A form of error can also arise from the way credit reports are used. This is most clearly seen in the form of identity theft.³³ I could wrongly claim to be Richard O. Hynes and apply for credit from a bank. Acting on my claim, the bank could mistakenly order Richard O. Hynes's credit report, see that it is outstanding (I assume), and extend a loan to me. I will, of course, fail to pay, and then the bank may sue the real Richard O. Hynes or harass him to try to get him to pay. Even if he avoids payment, these efforts can impose real harm. This harm is likely to be magnified when the bank assumes the role of furnisher by reporting the default in his name to the credit bureaus.

Just how commonly errors appear in credit reports is the subject of debate. Studies sponsored by consumer advocates claim error rates as high as seventy-nine percent,³⁴ while studies sponsored by industry groups find error rates as low as one-half of one percent.³⁵ The FTC recently completed a multi-year study, and the most widely publicized finding of the study is the twenty-one percent "material error" rate quoted above.³⁶ However, this twenty-one percent rate may overstate the number of errors that actually affect a consumer's welfare as this estimate defines "material error" as any change in a credit report after a consumer investigation.³⁷ When the FTC focuses solely on errors that could actually affect credit terms (defined as the terms of automobile credit offered to the consumer) the rate falls to just five percent.³⁸ Still, many will find this error rate unacceptably high.³⁹

³² See CFPB, *supra* note 15, at 21.

³³ For an extended discussion of identity theft, see Keith B. Anderson, *et al*, *Identity Theft*, 22 J. ECON. PERSP. 171 (2008); Lynn M. LoPucki, *Human Identity Theory and the Identity Theft Problem*, 80 TEX. L. REV. 89 (2001-02); Jeff Sovern, *The Jewel of Their Souls: Preventing Identity Theft Through Loss Allocation Rules*, 64 U. PITT. L. REV. 343 (2002-03).

³⁴ See National Association of State PIRGS, *Mistakes Do Happen: A Look at Errors in Consumer Credit Reports at 4* (2004) ("Altogether, 79% of the credit reports surveyed contained either serious material errors or other mistakes of some kind.").

³⁵ PERC, *U.S. Consumer Credit Reports: Measuring Accuracy and Dispute Impacts* (2011) at 50 ("This material impact rate in which participants' credit scores moved to a higher credit score tier following the resolution of their disputes was found to be 0.5% on average.").

³⁶ See FTC Report, *supra* note 4.

³⁷ *Id.* at page iv.

³⁸ *Id.*

B. *The Regulation of Credit Reporting*

Before the passage of the FCRA, the law of defamation was the primary tool used to regulate credit reports. At common law, defamation was a strict liability tort with regard to accuracy; a reasonable belief in the accuracy of the statement would not protect the speaker from liability for reporting false information.⁴⁰ However, the Supreme Court has imposed important exceptions to this rule. For example, the Supreme Court has ruled that speech about public figures is protected by a qualified immunity that shields the speaker from liability unless she acted with malice (knowledge of the falsity of the claim or reckless indifference to the truth).⁴¹ Most jurisdictions applied a similar qualified immunity to the credit reporting industry and for the same reason – they feared that a contrary rule would chill socially valuable truthful speech.⁴² The credit bureaus sought further protection from liability by forcing the users of their reports to promise not to share the reports with the subjects of the reports.⁴³ If the subjects could not learn of the contents, they were unlikely to bring a suit alleging a false statement.

The FCRA retains and even extends the industry's immunity through its preemptive powers. Originally the FCRA preempted “any action or proceeding in the nature of defamation, invasion of privacy, or negligence” based on information disclosed in credit reports “except as to false information furnished with malice or willful intent to injure such consumer.”⁴⁴ However, Congress later added additional preemptive sections, including one that appears to preempt state law regulation of many of the areas cov-

³⁹ The FTC completed a follow-up study on January 21, 2015. This further study did not change the main results from the study completed in December of 2012, but it did suggest that mistakes did not frequently reenter credit reports. See <http://www.ftc.gov/news-events/press-releases/2015/01/ftc-issues-follow-study-credit-report-accuracy>.

⁴⁰ See DAN B. DOBBS, *THE LAW OF TORTS* §§ 401, 417, at 1120, 1169 (2000) (“So far as the prima facie case at common law was concerned, defamation was a strict liability tort except that with slander the plaintiff often had to prove actual damages.”).

⁴¹ *New York Times v. Sullivan*, 376 U.S. 254 (1964). The Supreme Court has also held that a state cannot impose liability for false statements about a private individual unless the speaker was at least negligent, and a state cannot impose punitive damages unless the speaker had a higher level of *mens rea*. See *Gertz v. Robert Welch, Inc.*, 418 U.S. 323 (1974).

⁴² See Virginia G. Mauer, *Common Law Defamation and the Fair Credit Reporting Act*, 72 *GEO. L. J.* 95, 100 (1983-84); Jeremiah Smith, *Confidential Privilege for Mercantile Agencies*. *McIntosh v. Dunn II*, 14 *COLUM. L. REV.* 296 (1914).

⁴³ See Mauer, *supra* note 42, at 99-100 (“First, because credit reporting agencies operated in almost complete secrecy, a victim was unlikely to discover the existence of the erroneous information at the root of his credit problems until the statute of limitations precluded relief.”).

⁴⁴ 15 U.S.C.A. § 1681h(e) (West 1997).

ered by FCRA even if the alleged wrongdoer acted with malice.⁴⁵ Some courts have read this new language literally while others have not.⁴⁶

Most of the provisions in FCRA are targeted at the CRAs. To protect consumer privacy, the law insists that CRAs take steps to ensure that users of credit reports have a permitted purpose,⁴⁷ but the law defines permitted purpose broadly so that the reports can be used by creditors, insurers, employers, landlords, governments that are granting a license and others with a business purpose.⁴⁸ The FCRA prohibits CRAs from reporting most negative information once it is seven to ten years old,⁴⁹ though this limit does not apply if the consumer has applied for a loan or a life insurance policy above \$150,000 or a job paying more than \$75,000,⁵⁰ and prohibits the reporting of some medical information to creditors or property and casualty insurers.⁵¹

Several provisions of the FCRA are designed to reduce the number of misstatements in credit reports. The FCRA insists that CRAs adopt “reasonable procedures to ensure maximum possible accuracy”⁵² and insists that CRAs take reasonable steps to investigate consumer claims of errors in their reports.⁵³ The FCRA has granted consumers access to their credit reports since its enactment, and in 2003 Congress amended the FCRA to force the CRAs to provide consumers with one free copy of their credit report each year.⁵⁴ These provisions allow attentive consumers to identify and thereby reduce the number of misstatements in their credit reports. The FCRA tries to further protect consumers against identity theft by allowing them to include initial or extended alerts in their files.⁵⁵

The FCRA regulates the users of credit reports as well. As noted above, users must have a permitted purpose to view a report.⁵⁶ Users also play an important role in ensuring the accuracy of credit reports. If a user rejects a consumer’s application for credit, insurance, housing, etc. based on his or her credit report (an “adverse action”), it must provide the consumer

⁴⁵ 15 U.S.C.A. § 1681t (West 1997).

⁴⁶ See NATIONAL CONSUMER LAW CENTER, *supra* note 2, at 459-68 (for an extended discussion of this conflict).

⁴⁷ 15 U.S.C.A. § 1681e(a) (West 1997).

⁴⁸ 15 U.S.C.A. § 1681b (noting, however, that state laws sometimes ban the use of credit reports for some purposes, such as for employment purposes, *see infra* notes 72-73, or for insurance purposes, *see Avraham et al., supra* note 12, at 265).

⁴⁹ 15 U.S.C.A. § 1681c (West 1997).

⁵⁰ 15 U.S.C.A. § 1681c(b) (West 1997).

⁵¹ *Id.*

⁵² 15 U.S.C.A. § 1681e(b) (West 1997).

⁵³ 15 U.S.C.A. § 1681i (West 1997).

⁵⁴ 15 U.S.C.A. §§ 1681g, 1681j (West 1997).

⁵⁵ 15 U.S.C.A. § 1681c-1 (West 1997).

⁵⁶ 15 U.S.C.A. § 1681b (West 1997).

with a notice designed to encourage the consumer to check her report,⁵⁷ and, if the user is a creditor, the Equal Credit Opportunity Act insists that the user provide the consumer with a reason for the adverse action.⁵⁸

In 2003 Congress amended the FCRA to adapt this notice system to a world of risk-based pricing. Under the FCRA and the accompanying regulations, creditors must provide a notice if the terms offered to the consumer are materially worse than those offered to many other customers (usually around sixty percent).⁵⁹ These regulations do not apply to insurers or employers.⁶⁰

Until 1996 the FCRA imposed no duties on furnishers,⁶¹ and even today the obligations placed on furnishers are relatively weak. Furnishers are prohibited from reporting information that they have reasonable cause to believe to be inaccurate,⁶² but they can discharge this duty by simply posting an address where the consumer can send complaints.⁶³ In addition, consumers cannot sue furnishers for a breach of this duty,⁶⁴ and the government can only impose liability if it first obtains an injunction and the furnisher subsequently breaches this injunction.⁶⁵ Furnishers have an independent duty to investigate alleged errors that CRAs bring to their attention,⁶⁶ and consumers do have a cause of action to enforce this obligation.⁶⁷

Perhaps the most significant recent development in credit reporting is the fact that the Consumer Financial Protection Bureau has begun regular examinations of the major credit bureaus.⁶⁸ These examinations will, among other things, examine the procedures that the credit bureaus use to minimize the number of errors that they make themselves⁶⁹ and examine the procedures that they use to ensure that their furnishers are reliable.⁷⁰

Scholars and consumer advocates have advanced a number of proposed reforms to the FCRA. The current FCRA prohibits credit bureaus from reporting adverse events that are many years old as well as certain

⁵⁷ 15 U.S.C.A. § 1681m (West 1997); *see also* 15 U.S.C. §§ 1681g, 1681j (West 1997) (noting that the FCRA also gives the consumer a free credit report after he or she has suffered an adverse event).

⁵⁸ 15 U.S.C.A. § 1691d (West 1997).

⁵⁹ 12 C.F.R. §§ 222.72-.74, 16 C.F.R. §§ 640.3-.5.

⁶⁰ In *Safeco Insurance Co. of America*, the Supreme Court held that an insurer need only provide a notice of an adverse action if the consumer would have received better terms had the firm never checked the credit report. 127 S.Ct. 2201 (2007).

⁶¹ *See* NATIONAL CONSUMER LAW CENTER, *supra* note 2, at 17-21.

⁶² 15 U.S.C. § 1681s-2.

⁶³ *Id.* § 1681s-2(a)(1)(B).

⁶⁴ *Id.* § 1681s-2(c).

⁶⁵ *Id.* § 1681s(c)(5).

⁶⁶ *Id.* § 1681s-2.

⁶⁷ *Id.* §§ 1681n, 1681o.

⁶⁸ *See* <http://www.consumerfinance.gov/guidance/supervision/manual/>.

⁶⁹ *Id.* at 10-15.

⁷⁰ *Id.*

details about medical debt.⁷¹ Scholars and advocates have proposed new gag rules. The proposed gag rule with the greatest potential impact would prohibit the use of credit reports for employment except in limited circumstances. Ten states already limit the use of credit reports in employment,⁷² and Elizabeth Warren and other members of Congress have introduced legislation that would do the same on a national level.⁷³

Some countries require that creditors report a consumer's payment history to a central registry, but the United States does not.⁷⁴ A second major category of proposed reforms would impose reporting requirements on certain creditors and the credit bureaus. For example, Richard Brooks has proposed such a requirement for subprime lenders like payday lenders.⁷⁵

Two other categories of reforms are more relevant for this essay because their goal is to reduce the number of mistakes in credit reports. One category would mandate specific matching procedures that the credit bureaus must use,⁷⁶ perhaps the CFPB examinations are a de facto version of this. A second category of reforms would make it easier for consumers to sue the credit bureaus and their furnishers. As noted above, credit bureaus are only liable for their misstatements if they behaved negligently,⁷⁷ and the FCRA effectively imposes no liability on furnishers at all for the initial misstatement.⁷⁸ Furnishers may face some state law liability if they acted maliciously, but even then the FCRA may preempt state law.⁷⁹ Commentators have proposed reforms that would increase the liability of the credit reporting industry, though these take various forms. Some call for a narrow reading of the FCRA's preemption provisions to allow for liability under state law.⁸⁰ Others call for strict liability for the credit bureaus or the furnishers.⁸¹ The basic logic of these reforms is to force the industry to internalize the harm that their mistakes cause to consumers.

⁷¹ 15 U.S.C. § 1681c.

⁷² Use Of Credit Information in Employment 2013 Legislation, at <http://www.ncsl.org/research/financial-services-and-commerce/use-of-credit-info-in-employ-2013-legis.aspx>

⁷³ 'Senator Warren Introduces Legislation to Prohibit Employes from Requiring Credit Report Disclosure, at http://www.warren.senate.gov/?p=press_release&id=305.

⁷⁴ See Tullio Jappelli & Marco Pagano, *Information Sharing, Lending and Defaults: Cross-Country Evidence*, 26 J. BANKING & FIN. 2017 (2002).

⁷⁵ See, e.g. Richard R. W. Brooks, *Credit Past Due*, 106 COLUM. L. REV. 994 (2006).

⁷⁶ For a summary of proposed matching requirements, see Sovern, *supra* note 33, at 369-371.

⁷⁷ 15 U.S.C. § 1681o.

⁷⁸ See *supra* notes 62-67, and the accompanying text.

⁷⁹ See *supra* notes 44-46, and the accompanying text.

⁸⁰ See, e.g. Elizabeth De Armond, Preventing Preemption: Finding Space for States to Regulate Consumers' Credit Reports, working paper; Elizabeth De Armond, *A Dearth of Remedies*, 113 PENN STATE L. REV. (2008).

⁸¹ See, Sovern, *supra* note 33; Chris Jay Hoofnagle, *Internalizing Identity Theft*, 13 UCLA J. L. & TECH. 2 (2009).

II. THE SOCIAL COSTS OF CREDIT REPORT ERRORS

The argument for strict liability for credit report errors is superficially attractive as it appears to be a simple extension of the economic analysis of tort law. This analysis suggests that if we are not concerned with the victim's incentive to take care (e.g. contributory negligence), then strict liability is likely to lead to efficient outcomes by forcing the tortfeasor to internalize the harm that her actions cause.⁸² A properly set negligence standard can also cause the tortfeasor to take efficient precautions,⁸³ but courts must discern the efficient level of precautions, and victims may have difficulty proving that the tortfeasor failed to take these precautions. Moreover, the efficient level of precautions rarely eliminates the risk of injury. Once the tortfeasor takes this level of care, she no longer bears the risk of loss, and she will engage in too much of the activity.⁸⁴ One can reasonably argue that consumers cannot easily protect themselves against mistakes in their credit reports. It would therefore seem that holding the credit reporting industry liable for the harm that their mistakes impose on consumers would provide the industry with the incentive necessary to take a socially optimal level of care.⁸⁵

This essay does not attempt a full analysis of the proper scope of liability for credit report errors. Rather, it notes that there is a fundamental problem with the above logic that makes the analysis much harder. Strict liability causes the tortfeasor to take care by forcing her to internalize the private harm suffered by the victim, and in tort law this private harm is usually equal to the social harm. However, a consumer's loss from a credit report error is likely to substantially exceed the social cost of the mistake because the mistake will confer benefits on third parties. Part A uses an example to show that, if we make some simplifying assumptions, credit report errors impose no social costs at all; they merely transfer wealth from some consumers to others. Holding the industry strictly liable for the private loss of credit report errors could thus cause the industry to take an excessive level of precaution or chill the reporting of information. Part B discusses some likely consequences of relaxing the simplifying assumptions.

⁸² See, e.g., ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 204 (6th ed. 2012).

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ This is essentially the argument set forth by those who favor strict liability for credit bureaus. See, e.g., Sovern, *supra* note 33, at 373.

A. *A Simple Example*

To see why the harm that a consumer's private costs of credit report errors are likely to exceed the social costs, assume that one hundred consumers each borrow \$100 for one year in a competitive market. To make the math easier, assume that \$100 in the future is worth \$100 today, there is no time value of money, and that lenders are risk-neutral. Eighty of the consumers are low-risk; they will repay the debt with certainty. Twenty consumers are high-risk; they will repay the debt eighty percent of the time, and they will repay nothing the other twenty percent of the time. If credit reports allow lenders to perfectly distinguish between low and high-risk consumers, lenders will demand a promise of \$100 from the low-risk consumers and a promise of \$125 from the high-risk consumers so that the expected payment for each consumer is \$100. Lenders cannot charge less than these amounts or they would lose money and go out of business. They cannot charge more or a competitor would undercut them.

Now assume that the credit reports are imperfect. Because consumer groups typically complain about errors that lower a consumer's credit score, assume that credit reports only contain one type of error. The credit reports correctly identify every high-risk consumer as high-risk. However, the credit reports also misidentify nine of the eighty low-risk consumers as high-risk. Consumers with a clean (low-risk) credit report will continue to get loans for a promised repayment of \$100. Lenders may initially demand \$125 from the consumers with a bad (high-risk) credit report. If they did, they would find that their average repayment would be a little more than \$107.75 because the actual rate of default in the pool of consumers who appear to be high-risk is about fourteen percent,⁸⁶ not twenty percent. This is because nine of the twenty-nine members of this risk-pool never default (they are actually low-risk consumers). If the industry consistently misclassifies some low-risk consumers as high-risk, other lenders would see that those who lend to the high-risk pool earn an abnormally large profit. They would enter the high-risk market and drive the price down. If the actual default rate for those with bad credit reports is a little less than fourteen percent, competition should drive the required repayment down to \$116.

If those consumers who appear to be high-risk must promise to pay \$116, each of the nine misidentified consumers will suffer a very real \$16 loss – they are paying \$16 more than they would have had they been correctly identified. However, their aggregate \$144 loss (9* \$16) is exactly offset by the gain experienced by the twenty consumers who are truly high-risk. Each of the twenty high-risk consumers sees her promised payment fall by about \$9, but they will only make this payment twenty percent of the time so that their expected aggregate gain from the mistake is \$144

⁸⁶ The probability of default is $0.2 \cdot (20/29) = 0.1379$.

($20 \times \$9 \times 0.8$). From a social perspective, the credit report error may be no more damaging than a lottery operator misreading the number of a winning ticket, causing Alice to win the prize instead of Alan.

B. *Why Credit Report Errors May Create Costs*

The simple example presented in Part A ignored complicating factors that could cause credit report errors to create social costs. First, the example assumed that the high-risk consumers would borrow at a rate that reflected their true probability of default. However, they may be unwilling to borrow at this price because they place a value on receiving the loan that exceeds the cost of providing it to them. If this is true, it is not socially efficient for them to receive credit,⁸⁷ and the pooling created by credit report error misallocates resources.⁸⁸ Second, the example in Part A assumed that the misidentified consumers would borrow at a required repayment of \$116. Even if the high-risk consumers are willing to pay this amount, the low-risk consumers may refuse because they will have to pay the price more often (they do not default). As a result, the low-risk consumers may be more likely to leave the market; this is the problem of adverse selection. If they do leave, the high-risk consumers will continue to have to promise \$125; there is no offsetting benefit to the high-risk consumers. Third, credit report errors reduce the penalty for default and thus reduce the consumer's incentive to repay. Credit report errors can create a form of moral hazard.⁸⁹ Finally, lenders and the misidentified consumers have a strong incentive to find alternative screening or signaling mechanisms to identify those who are, in fact, low-risk. Most obviously, many consumers will spend substantial time and effort to correct errors in their credit file.⁹⁰ These efforts are especially burdensome for victims of identity theft.⁹¹

⁸⁷ Note that this analysis ignores distributional questions. While providing the high-risk consumers with credit may reduce aggregate wealth, it may still increase the wealth of the high-risk consumers. A full analysis of the distributional consequences of credit report errors is left for future work. For now, note that society might be able to achieve the same distributional results with less loss of efficiency through the tax and transfer system. *See, e.g.*, LOUIS KAPLOW & STEVEN SHAVELL, *FAIRNESS VERSUS WELFARE* (2002).

⁸⁸ There may be still other forms of misallocation, especially in other contexts. For example, a lender may want to adopt different precautions or procedures for the different types of borrowers. If the borrowers are misidentified, the lender will apply the wrong procedures.

⁸⁹ As noted below, however, other forms of moral hazard can actually imply that credit report errors raise social welfare. *See infra* notes 105-108 and the accompanying text.

⁹⁰ As noted below, however, lenders have other screening devices available to them.

⁹¹ *See supra* note 33.

III. CREDIT REPORT ERRORS, GAG RULES AND POOR PROXIES FOR RISK

Section III demonstrates that the social costs of a credit report error are likely to exceed the private costs to the victim because these mistakes confer benefits on those consumers who are not subject to the mistake. Offsetting benefits are a general problem for the law,⁹² but the problem is particularly acute in the risk-categorization context. Part A demonstrates that a credit report with mistakes can be thought of as a poor proxy for risk and that the insurance literature on risk-categorization is likely to offer important insights for the regulation of credit reporting.⁹³ Part B draws an analogy between credit report errors and the FCRA rules that prohibit credit bureaus from reporting useful information that allows users to predict consumer behavior.

A. *Analogy to Insurance Proxies*

Insurance companies can rarely measure risk directly or can only measure it at an unacceptable cost. As a result, they classify individuals based on some proxy for risk. Consider automobile insurance. Insurers would like to classify individuals based on their recklessness, but it may be impossible to precisely define a measure of recklessness much less test drivers for this. Insurers may therefore charge young males more than other drivers because they believe that this group behaves more recklessly than others. They do not have complete discretion in the choice of these proxies as the government regulates the proxies that insurance companies can use to sort individuals into risk categories.⁹⁴

Econometricians think of proxies as the true variable of interest measured with error.⁹⁵ If we think of it in this way, the link between credit report errors and risk-classification errors becomes obvious. We can think of a perfectly accurate credit score as the true variable of interest and a credit score constructed from a set of imperfect credit reports as a proxy.

To further illustrate this parallel, note that in Section II we considered an example in which a perfect credit report would have perfectly identified a consumer's risk level but that some credit reports contained errors. But we could just as easily frame the problem as one in which even a perfect

⁹² For example, if a public firm misstates its earnings, it may cause a buyer to pay too much for a share of stock, but it will correspondingly allow a seller to sell the share for more. For a more general discussion of the consequences of offsetting benefits, see Ariel Porat & Eric Posner, *Offsetting Benefits*, 100 VA. L. REV. 1165 (2014).

⁹³ See, e.g., Ken Abraham, *Efficiency and Fairness in Insurance Risk Classification*, 71 VA. L. REV. 403 (1985); Avraham, et al., *supra* note 12.

⁹⁴ *Id.*

⁹⁵ See, e.g., WILLIAM H. GREENE, *ECONOMETRIC ANALYSIS* 221 (7th ed. 2012).

credit report is an imperfect proxy for risk. For example, assume that the credit reports contain perfectly accurate records of past bankruptcy filings. Assume further that those debtors who have never filed for bankruptcy are certain to repay their debts in full. There are seventy-one of these debtors. Twenty-nine debtors have filed for bankruptcy previously. Twenty of these twenty-nine debtors are, in fact, high-risk and would default on a loan twenty percent of the time. However, nine of the twenty-nine debtors with a prior bankruptcy are actually low-risk; they will never default. They may have suffered some unavoidable medical shock that caused them to file for bankruptcy but from which they have fully recovered. The numbers chosen are, of course, precisely the same as those in Section II. The fact that nine of the low-risk debtors are misclassified as high-risk raises each of their required repayment by \$16 so that their private costs are costs are \$144 (9* \$16). However, the misclassification lowers the required repayment of each of the twenty low-risk debtors by \$9, and since each of them repays eighty percent of the time their collective benefit is also \$144.

One may object that the mistake in the credit report is different because it can be corrected. We should not underestimate the difficulty of correcting these errors. Indeed, consumers themselves may have difficulty determining the accuracy of the information in their files. After all, in January of 2015 the FTC completed a study that followed consumers with unresolved disputes from a prior FTC study, and they found that nearly a third (thirty-one percent) of consumers accepted the original information as correct.⁹⁶ But credit bureaus could almost certainly reduce the number of mistakes if they were willing to invest more money doing so. One study found that credit bureaus spent an average of just fifty cents investigating each disputed claim.⁹⁷

Note, however, that insurers and lenders could also likely improve the precision of their proxies if they were willing to spend more. Consider the above example. Lenders could interview the debtor to determine the reason for the bankruptcy filing. They may be dissuaded from doing so if these interviews were very costly. Some debtors may misrepresent their reason for filing for bankruptcy, just as some consumers wrongly claim that information in their file is incorrect.

If we consider the cost of accurately sorting between low and high-risks, society may not actually want greater accuracy. Scholars sometimes use this argument to justify limits on risk-classification.⁹⁸ The intuition is

⁹⁶ FEDERAL TRADE COMMISSION, REPORT TO CONGRESS UNDER SECTION 319 OF THE FAIR AND ACCURATE CREDIT TRANSACTIONS ACT OF 2003 III (2015), available at <http://www.ftc.gov/system/files/documents/reports/section-319-fair-accurate-credit-transactions-act-2003-sixth-interim-final-report-federal-trade/150121factareport.pdf>.

⁹⁷ See Anne Kadet, *Why the Credit Bureaus Can't Get It Right* (2009), available at <http://www.tnj.com/why-the-credit-bureaus-cant-get-it-right>.

⁹⁸ See, e.g., Avraham, et al, *supra* note 12, at 208-09.

that insurers or lenders must expend resources to sort between low and high-risk consumers, and they must recover these costs through the fees that they charge consumers. If the categorization just lowers costs for low-risk consumers and raises costs for high-risk consumers, then a ban may actually reduce average costs by an amount that reflects the cost of categorization.

Note that this same logic applies to credit report errors if one views the problem at a higher level of abstraction. Instead of considering the cost of a mistake, consider the social cost of the industry's failure to take sufficient care to avoid the mistake. To the extent that this care is costly, the industry must find a way to recover the costs through the charges passed on to consumers. If the errors merely raise the rates that some low-risk consumers must pay and lower the rates that truly high-risk consumers must pay, then society may be able to lower rates on average by accepting a lower level of care and a higher rate of error. In other words, a lower level of care that leads to a greater rate of error may be socially desirable.

B. *Analogy to FCRA's Gag Rule*

The FCRA instructs credit bureaus to make "reasonable efforts to ensure maximum possible accuracy," but it also contains provisions that make credit reports less accurate, at least if we interpret accuracy to mean reports that enable users to predict consumer success or failure. The FCRA prohibits credit bureaus from reporting old negative information⁹⁹ even though studies have shown that this information is relevant for predicting repayment.¹⁰⁰ This gag rule creates a form of credit report error, but it is an error of omission rather than commission. If we make the same simplifying assumptions that we used in Section II, then this gag rule merely transfers wealth from some consumers (truly low-risk consumers) to others (those who have the negative information removed from their files).

To see this, assume again that one hundred consumers will each borrow \$100 in a competitive market and that eighty consumers are low-risk and repay with certainty while twenty consumers are high-risk and default twenty percent of the time. Now assume that the law mandates that the credit bureaus delete the information that identifies nine of the twenty as high-risk. The eleven consumers correctly identified as high risk will continue to have to promise to pay \$125 so that they pay \$100 on average and the lenders break even. Naïve lenders may initially require a promise of just \$100 from the eighty-nine consumers with a clean credit report because

⁹⁹ See 15 U.S.C. § 1681c (prohibiting the reporting of negative information that is old unless certain exemptions apply).

¹⁰⁰ See David K. Musto, *What Happens When Information Leaves a Market? Evidence from Postbankruptcy Consumers*, 77 J. BUS. 725 (2004).

they think that the clean report means that they will be repaid with certainty. If they do so, however, they will lose an average of a little more than two dollars on each loan because the average rate of repayment for consumers with a clean report is now a little under ninety-eight percent.¹⁰¹ In a competitive market lenders will raise the price until they break even, charging about \$102.06.¹⁰² Collectively, the nine high-risk debtors who have their prior bankruptcy deleted receive a benefit of about \$165 as each of the nine sees a drop in the required repayment of about \$23 and each makes this payment eighty percent of the time. However, the eighty low-risk consumers see a corresponding \$165 loss as each of the eighty sees their required repayment go up by a little more than \$2 and they make this payment with certainty.

This simplified analysis is just a first approximation, and the gag rule could reduce average social welfare for the same reasons that credit report errors can reduce average social welfare. First, the omission of the negative information can cause misallocation by bringing some high-risk consumers back into the market. Unless one makes additional assumptions,¹⁰³ it is not efficient for high-risk consumers to obtain credit if the value they place on receiving this credit is lower than the cost of providing it to them. Second, the omission causes an increase in the price faced by the low-risk consumers, and this could lead to adverse selection by driving the good types from the market. Third, the omissions reduce the penalty for defaulting on a debt and thus create a form of moral hazard. Finally, the omissions could cause lenders and low-risk consumers to look for other screening and signaling devices. For example, lenders could demand collateral as this is more expensive for high-risk borrowers (they default more often),¹⁰⁴ or they could collect their own data on bankruptcy filings.

At least in theory, the gag rule could actually increase social welfare; the social cost of the error by omission could be negative. There are various theories for why this may be true,¹⁰⁵ but consider a recent paper by Elul

¹⁰¹ Nine of the eighty-nine consumers with a clean report are actually high-risk so that the average rate of default is $(9/89) \times 0.2 = 0.02022$.

¹⁰² This is $\$100/0.97978$.

¹⁰³ See *infra* note 105, and the accompanying text.

¹⁰⁴ See, e.g., Helmut Bester, *Screening vs. Rationing in Credit Markets with Imperfect Information*, 75 AMER. ECON. REV. 850 (1985).

¹⁰⁵ Two other papers, one by Vercammen and another by Moav and Neeman, can also be used to support this claim. See James A. Vercammen, *Credit Bureau Policy and Sustainable Reputation Effects in Credit Markets*, 62 ECONOMICA 461 (1995); Omer Moav & Zvika Neeman, *The Quality of Information and Incentives for Effort*, 43 J. INDUS. ECON. 62 (2010). These papers differ from Elul and Gottardi in that the gag rule improves efficiency by preserving asymmetric information so that borrowers have an incentive to work hard to develop a reputation for good quality, thereby mitigating the moral hazard problem.

& Gottardi.¹⁰⁶ Their paper presents a complicated model, but the basic intuition is straightforward. The primary subjects of their model are entrepreneurs who would be able to get a loan if they were able to commit to exerting a high level of effort. However, limited liability creates a form of moral hazard so that they will not exert a high level of effort if they are charged a rate that reflects their probability of default. A gag rule that allows these entrepreneurs to pool with lower-risk entrepreneurs (who don't have to exert effort to succeed) can reduce the interest rate on their loans just enough to cause the higher-risk entrepreneurs to exert enough effort to make loans to them profitable and efficient.

The key to the Elul & Gottardi model is that the gag rule creates an error by omission that allows the high-risk entrepreneurs to pool with the low-risk entrepreneurs.¹⁰⁷ However, one can create pooling by either adding stars to the bellies of the plain-bellied Sneetches or by removing the stars from the star-bellied Sneetches.¹⁰⁸ That is, one could also create pooling by adding (mistaken) negative information to the low-risk consumers, and so, in theory, credit report errors could actually improve social welfare in the same manner.

IV. CONCLUSION AND EXTENSIONS

In this essay I argue that a theoretical analysis of the effects of credit report errors is basically the same as a theoretical analysis of imperfect risk-categorization in insurance or laws that prohibit lenders from considering some negative information about debtors. Under simplifying assumptions, the social costs of these errors, imperfections and omissions are zero; they merely transfer wealth from some consumers to others. In reality, however, these errors, imperfections and omissions are likely to impose social costs (though they could also provide social benefits) because of misallocation, adverse selection, moral hazard and signaling or screening costs.

I do not claim that credit report errors always have the same practical effect as imperfections in risk-categorization or omissions of negative information. Context matters and one must make strong empirical assump-

¹⁰⁶ See Elul & Gottardi, *supra* note 13. Elul & Gottardi present a model of successive loans to an entrepreneur, but the FCRA's gag rule is unlikely to apply to such a loan. First, the gag rule does not apply if the credit report is used for high-dollar loans. See 15 U.S.C. § 1681c(b). Second, while the FCRA does apply to consumer reports that are used for business purposes, it would not apply to a report that only recorded a repayment history of business loans and was used for business purposes. See 15 U.S.C. § 1681a; NATIONAL CONSUMER LAW CENTER, *supra* note 2, at 30 ("A report on an individual's *business* history (as opposed to personal credit or employment history) is also not a consumer report if it was collected, used *and* expected to be used to evaluate business credit or insurance eligibility."). However, the basic intuition of the model can be applied to the consumer setting.

¹⁰⁷ This is also true of the models in Vercammen and Moav & Neeman. See *supra* note 104.

¹⁰⁸ DR. SEUSS, *THE SNEETCHES AND OTHER STORIES* (1961).

tions to predict the effect of a government intervention. Depending on the assumptions one makes, an inability of good types to identify themselves can cause markets to collapse entirely¹⁰⁹ or improve everyone's welfare.¹¹⁰ Moreover, the distributional effects of misstatements in a credit report are likely to be very different than those of the FCRA's gag rules.

I also make no claims about whether or how the FCRA should be reformed, or at least I do not do so in this essay. A normative analysis of the regulation of the credit reporting industry would require a careful analysis of the market structure of credit reporting and whether industry participants internalize the social costs of their mistakes. I expect to conduct this analysis in future research; this essay is just the first step.

¹⁰⁹ George Akerlof, *The Market for Lemons: Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970).

¹¹⁰ See, Phillippe Aghion & Benjamin Hermalin, *Legal Restrictions on Private Contracts Can Enhance Efficiency*, 6 J. L. ECON. & ORG. 381 (1990). The basic intuition is that a pooling equilibrium is unstable without regulation because the good types have an incentive to signal and thus get better contracts. However, the bad types will begin to mimic their signals, and the good types will end up spending so much on signaling that they would have been better off with a pooling equilibrium and no signaling.

BEHAVIORAL ECONOMICS AND CREDIT REGULATION

*J. Howard Beales III**

INTRODUCTION

The foundation of consumer protection policy is respect for consumer choice. Based on the economics of information and transaction costs, sound policy recognizes the need to preserve information markets and to carefully structure interventions to ensure compatibility with how consumers actually process information. Under the traditional approach, intervention in markets is appropriate only when some failure prevents the market from reaching the result that is best for consumers. Section I briefly lays out this approach to consumer protection.

Over the last decade, regulators have increasingly justified intervention in markets, particularly credit markets, based not on market failure, but rather on notions that amount to consumer failure. Behavioral economics argues that consumers make systematic errors that do not serve their best interests. The behavioral challenge, and four biases commonly cited as rationales for intervention in credit markets—hyperbolic discounting, framing effects, the endowment effect, and choice overload—are discussed in Section II.

Section III argues that three interrelated problems limit the applicability of behavioral economics to policy choices. First, the interaction of buyers and sellers in the market will moderate individual biases, but most behavioral analyses do not consider the impact on market equilibrium. Second, the experiments that are the foundation of behavioral economics may not predict real-world behavior. Third, behavioral economics offers many biases, but no theory of which biases matter in what circumstances.

Section IV considers default rules and behavioral economics. It suggests that default rules should be chosen to minimize transaction costs, and to place the transaction costs on those who receive the benefits of making a particular choice. Section V offers brief concluding remarks on behavioral economics and regulatory policy.

I. RATIONAL CHOICE IS THE FOUNDATION OF ECONOMIC ANALYSIS

The fundamental result of welfare economics is that competitive market outcomes maximize consumer welfare as judged by consumers, given the ini-

* Professor of Strategic Management and Public Policy, George Washington School of Business, April 2015.

tial distribution of resources. The model assumes that consumers act rationally to maximize their utility, choosing the products and services that best satisfy their preferences. Sellers, acting rationally to maximize their profits, respond to consumer preferences as revealed in the marketplace, which requires them to offer the kinds of products consumers most prefer. Competition among sellers prevents consumer exploitation, and pushes each seller to lower costs and offer the best possible deal to consumers. Each market participant is “led by an invisible hand to promote an end which was no part of his intention. . . . By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it.”¹ Government intervention in such a market can only make things worse.

Of course, the perfectly competitive markets of economic textbooks do not actually exist—any more than the perfectly rational government decision makers in political science texts. Nonetheless, competitive markets remain the standard for judging interventions—will a particular policy bring us closer to the ideal outcome that perfectly competitive markets would produce? Thus, market imperfections are the primary economic rationale for intervention. In the context of consumer protection, the most important imperfections are the costs of information and the costs of transactions.²

The textbook model of perfect competition assumes that all participants are perfectly informed. In reality, however, information is imperfect. If consumers lack information about price, sellers will have a certain amount of power over price, and can restrict output to raise the price. If consumers lack information about product characteristics, demand may not reflect the choices consumers would make with additional information. The result may be excessive consumption, if consumers lack information about negative characteristics of the product, or too little consumption, if consumers lack information about product benefits.³

A more informative analysis, however, starts from a different premise. Like everything else in life, information is costly. There are costs of producing information, costs of disseminating information, and costs to consumers of processing, understanding, and using the information they obtain. Because information is costly, it will not be optimal for consumers to become fully informed. Instead, one of the many decisions that consumers must make is how much information to obtain. Rational consumers will seek additional information until the marginal benefit of added information just equals the marginal cost of obtaining that information.⁴ The more it costs to obtain addi-

¹ ADAM SMITH, *THE WEALTH OF NATIONS* BOOK IV Ch. 2 (ReadaClassic ed. 2009) (1776).

² For a full discussion of the information and transactions cost rationales for government intervention, see J. Howard Beales III & Timothy Muris, *FTC Consumer Protection at 100: 1970s Redux or Protecting Markets to Protect Consumers*, GEO. WASH. L. REV. (forthcoming).

³ J. HOWARD BEALES III, *BUSINESS GOVERNMENT RELATIONS: AN ECONOMIC PERSPECTIVE* Ch. 2 (2nd ed. 2012).

⁴ George J. Stigler., *The Economics of Information*, 6 J. OF POLITICAL ECON. 213-225 (1961).

tional information, the more rational consumers will choose to remain uninformed. Beyond some point, reducing ignorance is simply not worth the costs.

Even with costly information, however, markets can produce competitive outcomes. Some consumers will be informed, whether about price or product characteristics. As long as the informed group is large enough to be worth competing for, their search for information will police the marketplace.⁵ Because sellers cannot easily discriminate between informed and uninformed consumers in most circumstances, they must offer a competitive price (or competitive terms on other product dimensions) if they wish to compete for the informed buyers.⁶ With enough informed buyers, the equilibrium outcome will be the competitive equilibrium, even though many buyers choose not to be informed.

Of course, given the importance of the costs of obtaining information, government actions that reduce the cost of information can improve market performance. Standardized measuring systems that facilitate product comparisons, for example, can ease the consumer's task of obtaining information and enhance competition on the measured dimension.⁷

Even when markets, including information markets, can function well, there may be a need for intervention due to the presence of transaction costs. Market participants must bear the costs of making decisions, forming contracts, negotiating contractual details, and enforcing those arrangements. Government policies and specific interventions can reduce transaction costs, and thereby enhance market efficiency.

Much of what government does to reduce private transaction costs is so basic it is often not thought of as regulation or intervention at all. The legal system of property rights, contract law, and laws against fraud greatly facilitates transactions. It is possible to imagine alternative arrangements that do not depend on government, and indeed such systems existed before modern contract law evolved. They were almost certainly, however, more costly and less efficient than the government-sponsored set of rules that has emerged.⁸

With consumer transactions, private legal remedies are far less likely to be adequate. A breach of contract that creates a small loss to each individual consumer may, in the aggregate, be quite profitable for the breaching party,

⁵ Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630, 637 n. 14 (1979).

⁶ Shopping occurs even for the terms of standard form contracts. See J. Howard Beales III & Timothy J. Muris, *The Foundations of Franchise Regulation: Issues and Evidence*, 2 J. CORP. FIN. 157, 165 (1995) (for evidence addressing shopping for standardized franchise contracts); see James R. Barth, Joseph J. Cordes, & Anthony M. J. Yezer, *Benefits and Costs of Legal Restrictions on Personal Loan Markets*, 29 J.L. & ECON. 157, 175-79 (1986) (for evidence of shopping for personal loan terms).

⁷ J. Howard Beales III, Richard Craswell, & Steven Salop, *The Efficient Regulation of Consumer Information*, 24 J.L. & ECON. 491, 523-27 (1981).

⁸ See Beales & Muris, *supra* note 2.

and yet not worthwhile for any individual consumer to pursue.⁹ These costs of enforcing rights are the rationale for both government enforcement and private class actions to aggregate small individual damages.

The FTC has used the prohibition on unfair practices to attach systematic breaches of contract, practices such as unauthorized billing, various forms of internet trickery, and failure of businesses to take reasonable precautions to prevent theft of sensitive consumer information.¹⁰ Only rarely has it used unfairness to attack particular contractual provisions, and then only after finding that there were in fact impediments that prevented competitive market outcomes.¹¹ The provisions of standard form contracts are elements of the product or service in the same way as any other design feature. Just as consumers cannot negotiate about the particular provisions of a standard form contract, they cannot negotiate about the details of the design of their automobile or the internal workings of their cellular phone. They can, however, choose a different offering from a different seller. Only when some identifiable factor prevents that choice is there a basis for second guessing the contract provision itself.

II. THE BEHAVIORAL ECONOMICS CHALLENGE

Behavioral economics, based largely on psychology and supported by a variety of laboratory experiments, raises a fundamental challenge to the market paradigm. In its strongest forms, prevalent in the behavioral law and economics literature, it argues that consumers make systematic errors that do not serve their best interests. Of course, few would doubt that consumers make mistakes in their choices from time to time. Behavioral economics, however, argues that these mistakes are biased in a particular direction, and that they are systematic. Thus, some argue that intervention in markets is necessary not to enhance market performance, but rather to protect consumers from their own mistakes.¹²

The list of potential biases is long. The Wikipedia entry for cognitive biases includes some ninety “decision-making, belief, and behavioral biases,” followed by numerous social biases and memory errors and biases.¹³ Unfortu-

⁹ See J. Howard Beales III, *The FTC's Use of Unfairness Authority: Its Rise, Fall, and Resurrection*, 22 J. PUB. POL'Y & MARKETING 192, 196-98 (2003).

¹⁰ *Id.*

¹¹ Credit Practices Rule: Statement of Basis and Purpose and Regulatory Analysis (SBP), 49 FR 7740, 7743-45 (1984).

¹² See Colin Camerer, Samuel Issacharoff, George Loewenstein, Ted O'Donoghue & Matthew Rabin, *Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism,"* 151 U. PA. L. REV. 1211, 1214 (2003); Cass R. Sunstein & Richard H. Thaler, *Libertarian Paternalism is Not an Oxymoron*, 70 U. CHI. L. REV. 1159, 1160 n. 6 (2003).

¹³ See List Of Cognitive Biases, http://en.wikipedia.org/wiki/List_of_cognitive_biases (last visited June 22, 2015).

nately, as discussed in more detail below, there is no general theory about when a particular bias applies, when it does not apply, or when it is important.¹⁴ Four biases, however, are widely cited in the literature, particularly with regard to credit regulation: hyperbolic discounting, framing effects, the endowment effect, and choice overload.

Perhaps most important in the context of credit is the claim that consumers engage in hyperbolic discounting.¹⁵ The most common economic analysis of choices over time assumes exponential discounting at a constant interest rate. Present consumption is preferred to future consumption, and consumers can borrow or lend to smooth the path of their consumption over time. With hyperbolic discounting, future effects are heavily discounted relative to current effects. Thus, for example, even though there may be net long run benefits to exercise, a consumer may choose not to go to the gym for a workout today because of the weight assigned to the current costs of exercise. This result may occur in the standard model as well. With hyperbolic discounting, however, longer term future effects are only slightly more discounted than more immediate effects that are still in the future. Thus the same consumer may plan to start an exercise program in the future. When the planned start date of the exercise program arrives, however, future benefits are again heavily discounted relative to current costs, and so the consumer again chooses not to go to the gym. Thus, with hyperbolic discounting, choices may be inconsistent—consumers may plan to do something in the future, and then change their minds when the time arrives.

Consumers who recognize that they may find it difficult to fulfill their plans for the future can make commitments to those plans in a variety of ways. Installment contracts, whole life insurance, and Christmas clubs can all be seen as financial contracts that impose constraints on future behavior.¹⁶ Experimental studies also indicate that consumers often adopt pre-commitment if there are costs to time inconsistent behavior.¹⁷

¹⁴ See Nathan Berg & Gerd Gigerenzer, *Psychology Implies Paternalism? Bounded Rationality May Reduce The Rationale To Regulate Risk-Taking*, 28 SOC. CHOICE WELFARE 337 (2007); see Jonathan Klick & Gregory Mitchell, *Government Regulation of Irrationality: Moral and Cognitive Hazards*, 90 MINN. L. REV. 1620, 1628 n. 20 (2006).

¹⁵ See Shane Frederick, George Loewenstein, & Ted O'Donoghue, *Time Discounting and Time Preference: A Critical Review*, 40 J. ECON. LITERATURE 351, 351-401 (2002) (for a review of the arguments and evidence on time preference); see also THOMAS A. DURKIN, GREGORY ELLIEHAUSEN, MICHAEL E. STATEN, & TODD J. ZYWICKI, *CONSUMER CREDIT AND THE AMERICAN ECONOMY* (2014) (for a fuller discussion in the context of credit regulation).

¹⁶ F. THOMAS JUSTER & ROBERT P. SHAY, *CONSUMER SENSITIVITY TO FINANCE RATES: AN EMPIRICAL AND ANALYTICAL INVESTIGATION* 88 (NBER ed., 1964).

¹⁷ Dan Ariely & Klaus Wertenbach, *Procrastination, Deadlines, and Performance: Self-Control by Precommitment*, 13 PSYCHOLOGICAL SCIENCE 219, 219-224 (2002).

Hyperbolic discounting may be a perfectly sensible strategy given uncertainty about the future.¹⁸ Not only are the future values of standard economic variables of prices and incomes uncertain, future preferences may be uncertain as well. In a series of experiments measuring changes in personalities, values, and preferences over time, Quoidbach and colleagues report that at all ages, respondents report that they have changed a lot over the past decade, but they expect to change relatively little in the future.¹⁹ The “future self” who makes choices inconsistent with the plan of the “present self” may have different preferences than the planner—as well as preferences that differ from those of a regulator.

Second, behavioral economists argue that choices are subject to framing effects: consumers may make different choices depending on whether the choice is framed as achieving a potential gain or avoiding a potential loss. In a classic experiment, respondents were asked to choose one of two treatments for 600 people suffering from a deadly disease. In the “positive” framing, respondents were asked to choose between a treatment that would save 200 lives and one that had a 1/3 chance of saving all 600 and a 2/3 chance of saving no one. 72% chose the certain alternative of saving 200 lives. In the “negative framing,” the alternatives were a treatment where 400 people would die, or a treatment with a 1/3 chance that no one would die and a 2/3 chance that all 600 would die. Although it is in fact the same choice, only 22% chose the certain alternative in which 400 people die.²⁰

Framing effects likely reflect the costs of processing information and making decisions. A particular frame focuses attention on certain aspects of the choice at the expense of others. Such effects are hardly a surprise. Properly framing a choice is the essence of successful marketing. Miller could presumably have marketed “low alcohol” beer, but “lite” beer was a much more attractive frame. Similarly, most consumers were willing to consume “lean finely textured beef,” but they revolted at “pink slime.”²¹ Properly framing an argument is also the essence of successful advocacy in politics, in court, or in academia.

Unfortunately for both advocates and marketers, there is no good theory of what constitutes the “right” frame, or a “neutral” frame for any particular choice. Instead, we rely on competition, with companies competing to frame choices in the manner that is most favorable to their own offerings. Although sellers can presumably take advantage of framing in the way they present a

¹⁸ See J. Doyne Farmer & John Geanakoplos, *Hyperbolic Discounting Is Rational: Valuing the Far Future with Uncertain Discount Rates*, YALE UNIVERSITY COWLES FOUNDATION FOR RESEARCH IN ECONOMICS Paper No. 1719 (2009).

¹⁹ Jordi Quoidbach, Daniel T. Gilbert, & Timothy D. Wilson, *The End of History Illusion*, 339 *SCIENCE* 96, 96-8 (2013).

²⁰ Amos Tversky & Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 *SCIENCE* 453, 453-458 (1981).

²¹ Josh Sanburn, *The Surprising Reason ‘Pink Slime’ Meat is Back*, *TIME* (Aug. 26, 2014), <http://time.com/3176714/pink-slime-meat-prices-bpi-beef/>.

product or service, there is little reason to fear adverse market consequences from truthful framing, even when there are alternative framings. Consumers make choices in a marketplace in which sellers of competing alternatives will also take advantage of framing. Some credit cards, for example, may push low annual fees, while others stress low rates or rewards features. Advertisers are skilled at presenting their product in the best possible light, but the evidence is clear that advertising enhances market performance.²² If alternative choices are each framed in the way that is most likely to appeal to consumers, there is little reason to think framing distorts those choices. Similarly, advocates compete to frame the issues in the light most favorable to their position. There is little reason to think that the net effect on the resulting choices is somehow a distortion of true preferences.

A third commonly cited cognitive bias is the status quo or loss aversion bias, also known as the endowment effect. According to this bias, consumers tend to prefer what they have, and are reluctant to give it up. In a classic experiment, some trinket is randomly given to half the group. The price recipients demand to give up the trinket is roughly twice the price non-recipients are willing to pay to acquire it. Rational choice, however, implies that the willingness to pay and willingness to accept prices should be the same.²³

The endowment effect, however, may be an experimental artifact. Plott and Zeiler find endowment effects in simple procedures with limited controls for possible misconceptions. With comprehensive controls for misconceptions, including an incentive-compatible mechanism to elicit valuations, comprehensive explanations, paid practice rounds, and anonymity, the effect disappears.²⁴ As discussed below, the Plott and Zeiler experiment is likely a better predictor of actual market outcomes.

Finally, choice overload argues that having too many choices makes choice harder. A classic experiment offered in-store sampling of jams. In one treatment, twenty-four flavors were available for sampling, while another treatment offered only six flavors. In the six flavor treatment, 30% of those who sampled made a purchase, but only 3% of those who sampled from twenty-four choices did so.²⁵ Thus, if there are too many choices, consumers may not participate in the market at all. More options may also lead to inferior choices as well. One study found that when 401(k) retirement plans offer more choices, consumers tend to allocate more to money market and bond

²² See J. Howard Beales III, Timothy J. Muris & Robert Pitofsky, *In Defense of the Pfizer Factors*, in THE REGULATORY REVOLUTION AT THE FTC: A THIRTY-YEAR PERSPECTIVE ON COMPETITION AND CONSUMER PROTECTION 83 (James C. Cooper, Ed., 2013).

²³ Daniel Kahneman, Jack L. Knetsch & Richard H. Thaler, *Experimental Tests of the Endowment Effect and the Coase Theorem*, J. POL. ECON. 1325, 1325-26 (1990).

²⁴ Charles R. Plott & Kathryn Zeiler, *The Willingness to Pay–Willingness to Accept Gap, the “Endowment Effect” Subject Misconceptions, and Experimental Procedures for Eliciting Valuations*, 95 AM. ECON. REV. 530 (2005).

²⁵ Sheena S. Iyengar & Mark R. Lepper, *When Choice is Demotivating: Can One Desire Too Much of a Good Thing?*, 79 J. OF PERSONALITY & SOC. PSYCHOL. 995, 997 (2000).

funds, rather than the stock funds that are the better long run investment alternative.²⁶

Choice overload is closely related to the well-established marketing concept of information overload.²⁷ Providing consumers with more information effectively increases the costs of finding the particular information that is of most value to them, because they must sort through the less relevant facts. If the costs are too high, consumers may not seek the information at all. Thus, marketing messages are brief, and seek to convey only the most important information to consumers.

Choice overload is often used to argue that consumers should be offered fewer choices, because more consumers will participate in the market and those who do will make better choices. More options, however, mean that consumers can better satisfy their preferences. The real issue (or at least a better framing of the issue) is how best to organize both choices and information to facilitate consumer decisions.

Numerous marketing practices have the effect of structuring and simplifying choices. Sellers may advertise only the most popular options, but offer other choices for consumers who want something different. Consumers may rely on trusted retailers to narrow the set of possible choices and recommend the best option. Bundling related products and services can also facilitate choice, enabling consumers to evaluate a package, rather than forcing evaluation of each component separately.

Profit motivated sellers are better at the task of structuring choices than even the most benign regulator. Consumers are not paralyzed with indecision when they enter a WalMart store with 150,000 choices, because the options are organized in a way that facilitates choice. Sellers receive constant market feedback about consumer responses to how choices are organized, as well as whether they are offering too many or too few alternatives. A store offering jam samples will likely quickly determine that twenty-four choices is more than the optional number. At best, a data-driven regulator might survey consumers occasionally, but few regulatory agencies do even that. Moreover, sellers have the ability and incentive to respond quickly to changing consumer preferences; regulatory revisions are inevitably delayed and slow.

Restricting options that are offered in the marketplace is presumptively bad. Profitable options make both consumers and sellers better off, and there is no reason to restrict them to “simplify” the consumer’s choice problem. Similarly, requiring sellers to identify all possible options or provide greater prominence for options that regulators think are superior is problematic, pre-

²⁶ Sheena S. Iyengar & Emir Kamenica, *Choice Proliferation, Simplicity Seeking, and Asset Allocation*, 94 J. PUB. ECON. 530, 530-539 (2010).

²⁷ See Joseph P. Mulholland, *Summary Report on the FTC Behavioral Economics Conference* (2007), <https://www.ftc.gov/reports/summary-report-ftc-behavioral-economics-conference> (hereinafter *Mulholland Summary*); see also Joel Rudd, *The Consumer Information Overload Controversy and Public Policy*, 2 POL’Y STUD. REV. 465, 465-73 (1983).

cisely because sellers have strong incentives to structure choices as efficiently as possible.

III. THE LIMITS OF BEHAVIORAL ECONOMICS

Three interrelated problems limit the applicability of behavioral economics to real-world policy choices. First, most behavioral models and findings do not take into account the moderating influence of the market itself. Second, much of the evidence for behavioral biases is experimental, and may not accurately predict real world behavior. Finally, there is no general theory of which biases are relevant or important in any particular context. These limitations are discussed in the following sections.

A. *Markets moderate consumer and producer behavior*

Economics studies the interaction of consumers and producers, *moderated by the market*. Compared to other social sciences, the concept of equilibrium is a unique component of economic analysis.²⁸ That equilibrium is determined by the marginal consumer, not the average or typical consumer. We would expect the average consumer participating in a market to believe that purchasing the product increases utility. The marginal purchaser, however, is indifferent between buying and not buying—and (given supply conditions) it is the marginal purchaser who determines the market price.

Even if many consumers deviate from rational choice, rational choices by the marginal consumer will yield market outcomes that are essentially what the rational choice model would predict. As discussed above, that is precisely what happens when information is imperfect: even if many (but not too many) consumers are uninformed, the full information, perfect competition model correctly predicts the market price. Even in standard form contracts, the marginal informed consumer drives the contract terms that are offered to all consumers.²⁹ Similarly, Schwartz finds that if some buyers are naïve and others are not, competition may drive out contracts that take advantage of naïve buyers.³⁰ As with imperfect information, the flaw does not necessarily prevent efficient outcomes.

Two aspects of market interaction are particularly important in considering the policy implications of behavioral economics. First, consumers learn from both their good experiences and their mistakes. In turn, learning reduces

²⁸ Edward P. Lazear, *Economic Imperialism*, 115 Q.J. ECON. 99, 102 (2000).

²⁹ See Beales & Muris, *supra* note 6 (for evidence addressing shopping for standardized franchise contracts); see Barth, Cordes, & Yezer, *supra* note 6 (for evidence of shopping for personal loan terms).

³⁰ Alan Schwartz, *How Much Irrationality Does the Market Permit?*, 37 J. LEGAL STUD. 131-159 (2008).

the influence of deviations from rational choice. Second, firms' responses to consumer biases may moderate their influence, and may create profit opportunities for products and services that either avoid or correct the bias. Without equilibrium models that allow reflection of these effects, we cannot assess the impact of any particular bias on market outcomes.

Consumers who exhibit behavioral biases experience losses. These losses may be actual losses, or they may be opportunity losses in the sense that a choice yielding higher utility was available. There is every reason to expect that consumers will learn from their experience, in particular when the losses are actual losses.³¹ The consumer will likely make a different decision from the one that led to the loss the next time the situation arises. Experiments that allow participants to learn over time find that learning eliminates observed behavioral phenomena in at least some circumstances. John List, for example, investigated endowment effects in trading card markets, and found that "individual behavior converges to the neoclassical prediction as market experience increases."³² Actual market participants are frequently repeat players, and may have considerable market experience. Moreover, learning may also be more general, leading consumers to make better choices in similar situations.

In general, consumers can make investments, such as in education, to learn how to make decisions in a particular type of choice situation, or they can learn from their experience with such choices over time.³³ Either approach to learning produces a stock of human capital, which yields benefits over time in the form of better decisions. Additional experience adds to that stock. Moreover, the stock of human capital is presumably subject to depreciation, either in the form of forgetting or changing circumstances that reduce the relevance of past knowledge or experience. Thus, the human capital stock is likely to increase over time as investments are made, and eventually decline as an age-shortened time horizon reduces investment incentives and depreciation takes its toll.

A recent study of consumer choices of credit card contracts found that most choose optimally, and that among those who made mistakes, those who made the largest mistakes were most likely to change.³⁴ There is evidence that consumers learn from the experience of paying late fees to avoid fees in the future. There is also evidence of forgetfulness, leading to additional mis-

³¹ Richard A. Epstein, *Behavioral Economics: Human Errors and Market Corrections*, 73 U. CHI. L. REV. 111, 111-15 (2006).

³² John A. List, *Does Market Experience Eliminate Market Anomalies?*, 118 Q.J. ECON. 41 (2003).

³³ Becker and Stigler use the household production model to explore a number of situations in which human capital stocks are important. See George J. Stigler & Gary S. Becker, *De Gustibus Non Est Disputandum*, 67 AM. ECON. REV. 76, 76-90 (1977).

³⁴ Sumit Agarwal, Souphala Chomsisengphet, Chunlin Liu & Nicholas S. Souleles, *Do Consumers Choose the Right Credit Contracts?* THE REVIEW OF CORPORATE FINANCE STUDIES Working Paper (2015), http://papers.ssm.com/sol3/papers.cfm?abstract_id=2478170.

takes.³⁵ Compared to middle aged consumers, younger consumers learn more slowly, while older consumers both learn more slowly and forget more quickly.³⁶ This is exactly what one would expect from a stock of human capital in bill-paying habits. A similar pattern has been observed in a number of other financial decisions.³⁷ Miravete and Palacios-Huerta also found that consumers learned rapidly to make optimal decisions about which telephone pricing scheme to choose.³⁸

Firm responses are also likely to affect the market relevance of behavioral findings. Competitive framing of a choice, as discussed above, is one such response. Firms' incentives to sell their product can affect the market response to other potential behavioral biases as well. If, for example, consumers discount future consequences too heavily, sellers of products or services with long-term benefits have incentives to try to make those consequences more vivid and more salient to the consumer.³⁹ If complex pricing plans are difficult for consumers to understand, firms in competitive markets have incentives to simplify those plans to attract customers.⁴⁰

The mix of consumers, consumer learning, and firm responses to consumer choice patterns (or mistakes) will influence the resulting market equilibrium, even if behavioral principles are relevant to some consumers. Without understanding the equilibrium market impact of particular biases, there is little basis for policy intervention. As the Australian Productivity Commission noted, "conventional economic models explain outcomes 'as if' people behave optimally. The inability to pinpoint the dynamic, actual process that makes most markets efficient, is simply reflective of why Adam Smith called it the *invisible hand*."⁴¹

³⁵ Sumit Agarwal, John C. Driscoll, Xavier Gabaix, & David Laibson, *Learning in the Credit Card Market* 3 n. 7, NBER WORKING PAPER 13822 (2008), <http://www.nber.org/papers/w13822.pdf>.

³⁶ Sumit Agarwal, John C. Driscoll, Xavier Gabaix & David Laibson, *Stimulus and Response: The Path from Naïveté to Sophistication in the Credit Card Market* 17 (Paper presented at the FTC Conference on Behavioral Economics and Consumer Policy, Washington, DC, 2007).

³⁷ Sumit Agarwal, John C. Driscoll, Xavier Gabaix & David Laibson, *The Age of Reason: Financial Decision-Making over the Lifecycle with Implications for Regulation* 1-76 (Brookings Papers on Economic Activity, 2009), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=973790.

³⁸ See Eugenio J Miravete & Ignacio Palacios-Huerta, *Consumer Inertia, Choice Dependence and Learning from Experience in a Repeated Decision Problem*, 96 REVIEW OF ECONOMICS AND STATISTICS 524, 524-537 (2014).

³⁹ This point was made by Pauline Ippolito at the FTC Behavioral Economics Conference. See Mulholland Summary, *supra* note 23 at 19.

⁴⁰ Miravete & Palacios-Huerta, *supra* note 31.

⁴¹ Review of Australia's Consumer Policy Framework, 2 AUSTRALIAN GOVERNMENT PRODUCTIVITY COMMISSION 383 n. 3 (2008), <http://www.pc.gov.au/inquiries/completed/consumer-policy/report/consumer2.pdf>.

B. *Experiments may not predict real world behavior*

The primary evidence supporting behavioral economics predictions is experimental, derived in a wide variety of laboratory settings. There is much that can be learned from experimental economics, and practitioners have made great strides in creating experimental environments that mirror real markets as closely as possible. Moreover, empirical behavioral economics research is increasingly moving to field experiments, in which an offer is manipulated in the context of an actual choice in the market.⁴² Nonetheless, laboratory findings remain the foundation of behavioral economics. By their nature, experiments are designed to test predictions; they do not in and of themselves generate testable hypotheses.

From the beginnings of experimental economics, there have been questions about the applicability of laboratory results to real-world economic problems. Participants in laboratory experiments, often students, may be less motivated and pay less attention than real consumers devoted to solving their own problems.⁴³ In experiments, higher rewards tend to shift observed outcomes toward the predictions of the rational choice model.⁴⁴ Nevertheless, the real-world consequences of decisions are likely large compared to the typical laboratory payoff. The significance of consequences also appears in real world choices: higher paid workers with more to lose from poor choices are less likely to rely on default choices for retirement plans.⁴⁵

Even at their best, most of the experiments relevant to behavioral economics measure the average consumer, and tell us little about the marginal consumer who is crucial to the market equilibrium. By their nature, these experiments compare the average of some outcome in the one group with the same average in another group that was treated differently. Knowing the average, however, tells us little about the marginal behavior that most matters in markets.⁴⁶ Moreover, forced choices in experiments may differ from market behavior, where one of the options is not to participate at all. Experiments using the “dictator game,” for example, in which a “dictator” is given a sum of money to either keep or divide with another participant as the dictator chooses,

⁴² For example, much of the research presented at the FTC Conference on Behavioral Economics and Consumer Policy was based on field experiments. See Mulholland, *supra* note 23.

⁴³ Steven D. Levitt & John A. List, *What Do Laboratory Experiments Measuring Social Preferences Reveal About the Real World?*, 21 J. ECON. PERSPECTIVES 153, 153-174 (2007); John A. List, *The Behavioralist Meets the Market: Measuring Social Preferences and Reputation Effects in Actual Transactions*, 114 J. POL. ECON. 1, 18 (2005).

⁴⁴ Vernon L. Smith & James M. Walker, *Monetary Rewards and Decision Cost in Experimental Economics*, 31 ECON. INQUIRY 245, 245-261 (1993).

⁴⁵ Brigitte C. Madrian & Dennis F. Shea, *The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior*, 116 Q.J. ECON. 1149 (2001).

⁴⁶ Edward Lazear, Remarks at the FTC Conference on Behavioral Economics and Consumer Policy at 14, Washington, DC (Apr. 20, 2007), https://www.ftc.gov/sites/default/files/documents/public_events/conference-behavioral-economics-and-consumer-policy/transcriptopen.pdf.

find high levels of sharing. If participants are given the option to opt out of playing, however, the overall level of sharing falls significantly.⁴⁷ Given the choice in an actual market, participants whose behavior drives experimental results may simply choose not to play.

Changes in consumer protection policy or interventions based on behavioral principles will play out in real markets. Before adopting such policies, we should have some empirical evidence that the particular principle supporting the intervention is actually observable in the marketplace. At present, such evidence is scant.

C. There is no theory of which biases are relevant in any particular context

Most, if not all, predicted departures from fully informed rational decision making have a specific theoretical basis, often drawn from psychology. As the Australian Productivity Commission noted, however, a common theme of the behaviorist literature is that behavior depends on the environment,⁴⁸ and there is no cohesive body of theory that tells us which departures are likely to be important in any particular context.⁴⁹ The lack of a theory is particularly important given the large number of potential biases that have been identified, as discussed above.

Consider, for example, cooling-off periods, which give consumers some period of time to think through their decision. Some behavioral economists have argued this remedy allows consumers to overcome the biases of hyperbolic discounting or myopia.⁵⁰ One could argue equally well that a cooling-off period reduces the perceived risk of a purchase, and that consumers will overestimate the likelihood that they will revisit their decision. Moreover, once the purchase is made, one might expect that the status quo bias would be relevant, and consumers would be reluctant to part with their purchase.⁵¹ On these arguments, cooling-off periods might reduce consumer welfare. The vast majority of purveyors of fraudulent products that the FTC has pursued offer money-back guarantees, which would seem to be the functional equivalent of a cooling-off period. It seems safe to say that these sellers are trying to reduce the

⁴⁷ Edward Lazear, Ulrike Malmendier & Roberto Weber, *Sorting in Experiments with Application to Social Preferences*, 4 AM. ECON. J.: APPLIED ECON. 136, 136-163 (2012).

⁴⁸ Australian Report, *supra* note 36, at 375.

⁴⁹ Berg & Gigerenzer, *supra* note 14; Klick & Mitchell, *supra* note 14.

⁵⁰ OECD, DIRECTORATE FOR SCIENCE, TECHNOLOGY & INDUSTRY, COMMITTEE ON CONSUMER POLICY ROUNDTABLE ON DEMAND SIDE ECONOMICS FOR CONSUMER POLICY: SUMMARY REPORT 17 (2006).

⁵¹ Joseph P. Mulholland, *Behavioral Economics and the Federal Trade Commission*, (Paper presented at the Australian Productivity Commission's Roundtable on Behavioral Economics and Public Policy, Melbourne, 2007); Mulholland Summary, *supra* note 19, at 27.

perceived risk of the purchase, not providing a chance for consumers to reconsider their decision.

Similarly, consider the impact of credit card rewards programs. Some argue that because the rewards reduce the effective cost of current purchases, consumers who exhibit hyperbolic discounting may increase current purchases, resulting in more future debt.⁵² Others argue that credit cards reduce the pain of paying, and may therefore lead to “over-indebtedness,”⁵³ or the systematic overuse of credit cards.⁵⁴ Rewards cards, which literally pay consumers for current transactions, should be particularly prone to this bias. Either argument implies that consumers who obtain a new rewards card should be more likely to carry a balance on the card than those who obtain new cards without a rewards feature. Still others argue that rewards are often deferred, thereby reducing their importance for current choices, or that the fear of effectively losing the reward by having to pay interest on an outstanding balance would reduce the incentive to carry a balance on a rewards card.⁵⁵ In fact, consumers are less likely to carry a balance on a new rewards card than on other new cards,⁵⁶ contradicting one behavioral story, but not the other. Testing the applicability of a theory to real markets is difficult when its predictions are so uncertain.

Other behavioral predictions also fail in the market for new credit cards. In particular, according to the behavioral story, consumers should accumulate more debt over time as they succumb to the temptations of current consumption. Thus, the likelihood of carrying a balance should increase over time. In fact, however, consumers who carry a balance on a new card reduce that balance over time.⁵⁷ Moreover, some have argued from a behavioral perspective that the absence of an annual fee is just another way to reduce the immediate pain of paying, and should be associated with an increased likelihood of revolving.⁵⁸ From a rational choice perspective, however, consumers who plan to revolve should choose cards with higher annual fees and lower interest rates, because that combination is likely to reduce the overall costs of borrowing. Thus, higher fees should be associated with a greater likelihood of revolving.

⁵² Oren Bar-Gill, *Seduction by Plastic* 25-28 (Berkeley Electronic Press, Working Paper, 2004).

⁵³ George Loewenstein & Ted O’Donoghue, *We Can Do This the Easy Way or the Hard Way, Negative Emotions, Self-Regulation, and the Law*, 73 U. CHI. L. REV. 183, 183-206 (2006).

⁵⁴ Ronald J. Mann, *Credit Cards, Consumer Credit & Bankruptcy*, U. OF TEX. LAW AND ECON. Working Paper No. 44 at 198 (2005), available at <http://www.ssrn.com/abstract=690701>.

⁵⁵ *Session F: Consumer Choice: Credit Cards*, FTC Conference on Behavioral Economics and Consumer Policy at 39-40, Washington, DC (Apr. 20, 2007), https://www.ftc.gov/sites/default/files/documents/public_events/conference-behavioral-economics-and-consumer-policy/transcriptf.pdf.

⁵⁶ J. Howard Beales III & Lacey L. Plache, *Rationality, Revolving, and Rewards: An Analysis of Revolving Behavior on New Credit Cards*, 21 SUP. CT ECON. REV. 133, 133-156 (2013).

⁵⁷ *Id.*

⁵⁸ See e.g., Bar-Gill, *supra* note 52.

ing. Empirically, consumers who hold cards with no annual fee are less likely to carry a balance.⁵⁹

Using behavioral principles as a basis for policy interventions requires policymakers to assume that the relevant principle is applicable in the context of that intervention. Without a theory that predicts which deviations from rational choice are even relevant in a particular context, let alone which are most important, there is little basis for that assumption. Particularly in the absence of a clear theoretical basis, policy interventions should have a more solid foundation than laboratory experiments.

IV. DEFAULT RULES AND BEHAVIORAL ECONOMICS

Frequently, default rules—what happens in the absence of an affirmative choice to do something differently—are “sticky.” That is, most consumers choose whatever is specified as the default. In some circumstances, that is precisely what we would expect, because the default was set on the basis that it was the choice most people would make. Default terms in contracts, for example, are chosen in part to minimize transactions costs by avoiding the need to bargain over a particular term.⁶⁰

When there is no obvious relationship between defaults and the choice most consumers would make, however, the fact that most people choose the default anyway is more surprising. In European countries where the default rule is that a deceased person’s organs will be donated, organ donation is much higher than in countries where the default is no donation.⁶¹ Perhaps differences in national culture dictate both the default rule and the difference in outcomes, but it seems unlikely. Similarly, participation in retirement savings plans is much higher if the default is that a portion of the worker’s salary will be contributed than if the default is no contribution to the plan.⁶² Online privacy choices are also heavily influenced by the default rule. If the default is that information is shared (or to receive e-mail communications from a website), most people share; if the default is no sharing, most people do not share.⁶³

Some argue that default rule stickiness is itself a result of a behavioral bias. It could be that the endowment effect applies, leading to a bias in favor of

⁵⁹ Beales & Plache, *supra* note 56.

⁶⁰ See Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Default Rules*, 101 YALE L.J. 729, 732 (1992); see Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CALIF. L. REV. 261, 265-66 (1985).

⁶¹ Eric Johnson & Daniel Goldstein, *Do Defaults Save Lives?*, 302 SCI 1338, 1339 (2003).

⁶² Madrian & Shea, *supra* note 45.

⁶³ Eric J. Johnson, Steven Bellman & Gerald L. Lohse, *Defaults, Framing and Privacy: Why Opting In-opting Out*, 13 MARKETING LETTERS 5, 5-15 (2002).

maintaining the status quo.⁶⁴ Or it could be that hyperbolic discounting leads to procrastination and inaction, leaving the default choice in place.⁶⁵ Still others argue for choosing default rules as a remedy for other biases. Thus, they contend, we should choose the default rules that are, in the policy maker's judgment, "best" for consumers, but let them opt out if they disagree.⁶⁶

An alternative view of default rule stickiness is that both obtaining information and making decisions are costly activities. Thus, changing from the default is costly, not because of the often low costs of checking a different box but rather because of the costs of information about the choice and the cognitive costs of considering the issue. Consumers may decide that a decision is not worth the cognitive costs of thinking about an issue at all, particularly when the stakes are small. Thus, few consumers read privacy policies⁶⁷ or give much thought to organ donation.⁶⁸

This transactions cost view of default rule stickiness suggests two goals in the choice of default rules. First, we should seek to minimize transactions costs by choosing the option that most consumers would choose if they considered the issue. Conceptually, this is the same approach as choosing a default contract term when the parties never bargained about the issue.

Second, default rules should be designed to impose the costs of transactions on consumers who think these costs are worth paying. With this approach, markets can reveal information about how many consumers think the costs are worthwhile, as well as the intensity of their preferences, in the same manner that the market for any product tells us something about how many, and how much, consumers care. An "opt out" default rule means that consumers who do not think that decision-making costs are worthwhile do not need to bear those costs. Consumers who care more intensely, however, will face the costs of making a decision. In contrast, an "opt in" default rule enables those who care the most about the issue to avoid the decision costs, because the default will match their preferences. The costs of making decisions and exercising a choice would be imposed on those who do care the least, who are least likely to be willing to pay those costs. For example, experiments have found that among consumers who are more concerned about privacy, there is no difference in participation whether the default rule is opt in or opt out.⁶⁹ Among

⁶⁴ Russell Korobkin, *Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608, 625 (1997).

⁶⁵ James J. Choi, David Laibson, Brigitte C. Madrian & Andrew Metrick, *Optimal Defaults*, 93 AM. ECON. REV. 180, 180-185 (2003).

⁶⁶ See Sunstein & Thaler, *supra* note 12.

⁶⁷ Keith Regan, *Does Anyone Read Online Privacy Policies*, E-COMMERCE TIMES (June 15, 2001), <http://www.ecommercetimes.com/story/11303.html>.

⁶⁸ Richard Posner, *Organ Sales—Posner's Comment*, THE BECKER-POSNER BLOG (Jan. 1, 2006), <http://www.becker-posner-blog.com/2006/01/page/2/>.

⁶⁹ Yee-Lin Lai & Kai-Lung Hui, *Internet Opt-in and Opt-out: Investigating the Roles of Frames, Defaults and Privacy Concerns*, Proceedings of the 2006 ACM SIGMIS CPR Conference on Computer Personnel Research at 253 (2006).

consumers who were less concerned about privacy, the default rule mattered, but among those who *were* concerned, it did not. Thus, opt out is a preferable default rule, because it avoids imposing costs on consumers who do not think the issue is worth the costs of making a decision. Moreover, it reveals information about how many consumers care enough to incur at least the costs of making a decision.

V. BEHAVIORAL ECONOMICS AND REGULATORY POLICY

Behavioral economics offers many useful insights into consumer behavior, and can inform policy choices. Like other interventions, however, choices based on behavioral principles must be tested against actual market behavior. The need for testing behavioral approaches is particularly acute because of the absence of a clear theory of which biases apply in particular circumstances.

It is clear that well-intentioned interventions can lead to worse consumer decisions. An FTC study of yield spread premium disclosures, for example, found that with disclosures, fewer consumers were able to identify the lower cost mortgage.⁷⁰ Studies of the CARD Act have found that consumers are more likely to make the payment that would be required to pay off the balance in three years. Because the required payment is recalculated each month, however, a consumer following this strategy will never pay off the outstanding balance.⁷¹

Even with careful market research, most new products introduced to the marketplace are failures. Policy interventions based largely on theory can expect a similar fate, but they are much more difficult to revise. Although much promising work is under way, at present, we do not have an empirical foundation for behavioral economics that would justify significant changes in regulatory policy.

⁷⁰ James Michael Lacko & Janis K. Pappalardo, *The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment*, FEDERAL TRADE COMMISSION (2004).

⁷¹ Dennis Campbell, Claudine Gartenberg & Peter Tufano, *Reframing Behavior: The Impact of the CARD Act on Cardholder Repayment Rates* (Consumer Financial Protection Bureau CARD Act Conference, Washington, 2011).

DIFFERENCES IN CONSUMER CREDIT CHOICES MADE BY BANKED AND UNBANKED MISSISSIPPIANS

*By Thomas W. Miller, Jr.**

ABSTRACT

This paper presents the results of a 2011 survey of a random sample of 400 Mississippians. The survey questions center on the use of non-bank supplied consumer credit products.

By usage, evidence from the survey suggests that these consumers did not largely rely on credit products that might ensnare them in the so-called “debt-trap.” The survey respondents used payday loans least often. About three times as many Respondents used title loans and/or pawn loans—both of which are secured by collateral and are non-recourse. Respondents used installment loans much more often than any non-installment loan product.

The survey asks two previously underexplored questions: 1) Do consumers know where to go to get a loan that suits their needs? and 2) Do consumers understand the terms of their loans?

Concerning how confident Respondents were in knowing where to obtain a loan, two factors matter: whether the Respondent has a bank account and whether their education level stops at high school.

Concerning how confident Respondents were in understanding the terms of the loan, one factor matters: whether their educational level of stops at high school. Having a bank account is unrelated, statistically speaking, to the confidence Respondents displayed about understanding the terms of the loan.

“[I]f the test of a subject’s historical importance is the amount of controversy it generated, then consumer credit is one of the most significant subjects in the history of the American twentieth century.”

---Lendol Calder (1999)¹

* Thomas W. Miller, Jr., Mississippi State University Jr. is a Professor of Finance and Economics, and the *Jack R. Lee Chair in Financial Institutions and Consumer Finance*. Professor Miller is a Visiting Scholar at the Mercatus Center at George Mason University. I thank Dr. Becky Campbell Smith for generously adding my questions to the survey she designed. I thank participants at the *Eleventh Annual Symposium of the Journal of Law, Economics, and Policy: A Symposium on Consumer Credit and the American Economy* for their comments. I also thank members of the Mercatus Center staff for their creativity and feedback, especially Rob Raffety and Hester Peirce. I thank Carolyn Moore Miller for research and invaluable editing assistance with this manuscript. I also thank Frank Adams for conferring with me on various aspects of reporting the survey results. Chris Bollinger provided useful

INTRODUCTION AND OVERVIEW

The topic of consumer credit, especially small dollar loans, continues to generate passionate debate. The decades-long debate has spawned a remarkable patchwork of inconsistent regulations and laws concerning small dollar loans. For example, some states prohibit access to some forms of consumer credit, while neighboring states prohibit access to other forms of consumer credit.²

The continued existence of small dollar consumer credit products, despite the ever more restrictive web of regulation, confirms there is a demand for these types of consumer credit. Even if lawmakers banned all types of consumer credit, consumers would simply seek out illegal sources of credit.³

To arrive at well-formed public policy concerning issues in consumer credit, logic dictates that, at minimum, all participants in the debate use the same set of facts. Unfortunately, for many current important consumer credit policy questions, there is a lack of rigorous empirical studies in this particular area.⁴ It is incumbent, therefore, on researchers to present rigor-

econometric recommendations. Special Acknowledgment: I first heard about the book, "Consumer Credit and the American Economy," on a trip, courtesy of Mr. Franc Lee, to the American Financial Services Association (AFSA) headquarters in Washington, D.C. During the conversation with Dr. Tom Durkin and Dr. Greg Elliehausen, I learned that they had a preliminary manuscript on consumer credit. Through the kindness of these authors, I was able to use their manuscript in class for two years before *Oxford University Press* published the book. Each time I read the book, I am astounded at the depth and breadth of knowledge displayed by these authors. I thank them greatly for their willingness to share their pre-published manuscript. This paper builds on some material found in that book. I thank the authors, particularly Todd Zywicki, Tom Durkin, and Greg Elliehausen, for encouraging my research in consumer finance.

¹ LENDOL CALDER, *FINANCING THE AMERICAN DREAM: A CULTURAL HISTORY OF CONSUMER CREDIT* 13-14 (1999).

² As discussed in Onymbe (Ben) Lukongo & Thomas W. Miller, Jr., *The Consequences of the Constitutional Interest Rate Cap in the State of Arkansas* (Mississippi State University, Working Paper, 2015), consider the availability of some consumer credit products in the state of Arkansas. On March 18, 2008, Arkansas Attorney General Dustin McDaniel sent letters to 156 payday lenders, ordering them to stop issuing new loans and void any current and past due loans or face legal action. The last payday lending business in Arkansas closed on August 11, 2009. In addition, the Arkansas Constitution imposes a 17% interest rate cap on any loan—thereby rendering small dollar loans uneconomical for installment lenders. Arkansas citizens, however, can drive to nearby states and obtain small dollar installment loans.

³ Illegal lenders charge more for their loans because they bear the additional risk of prosecution and conviction for their illegal activity. Loan sharking is an important source of income for organized crime. The going interest rate on loan shark loans has traditionally been twenty percent per week, or an annual percentage rate (APR) of 1,040%. CARL SIFAKIS, *THE MAFIA ENCYCLOPEDIA* 266 (3rd ed. 2005).

⁴ For example, Durkin and McAlister's 1977 report is probably the last comprehensive study published concerning finance companies and their installment loan product. See THOMAS A. DURKIN & EDGAR RAY MCALISTER, *AN ECONOMIC REPORT ON CONSUMER LENDING IN TEXAS* (Purdue Univ.,

ous, data-driven results to lawmakers, policy advocates, and other interested parties.

To provide helpful information to policy makers, the focus of this paper is on how consumers in Mississippi use non-bank supplied consumer credit products. Specifically, this research documents what consumers themselves have to say about which credit products they use.

The demand for small dollar credit products exists. Lusardi, Schneider, and Tufano examine the ability of American households to come up with \$2,000 within thirty days to help weather a financial shock.⁵ They document that approximately one-half of American households certainly could not, or probably could not, do so. Consequently, when faced with a financial shock that requires a payment, these household likely need access to some form of credit. Because of the economics of their business model, banks generally do not lend sums of \$2,000 or less. In light of these findings, the non-bank supplied loan space takes on even more importance.

There are many ways for consumers to obtain non-bank supplied credit. These products have starkly different features and clientele. It is incumbent upon anyone who opines about non-bank supplied credit to know these differences. That is, it is imperative to avoid lumping all these products together under the umbrella of “high cost loans” or “small dollar loans.” These credit products differ substantially from one another, just as do other consumer services. Appendix A contains a detailed description of four different small dollar personal loan and financing products.

Recent research documents the importance of keeping non-bank supplied credit products available to consumers. For example, Zywicki and Okolski conclude: “The bottom line is that restrictions on auto title lending will eliminate an important funding option for many consumers, especially those of lower income, and will incentivize the use of more risky or dangerous credit channels.”⁶ In addition, Fritzdixon, Hawkins, and Skiba conclude: “Instead of banning title lending, policymakers should foster a market with information that will help customers understand the true cost of title loans.”⁷ Morse studies the payday loan market and finds that “commu-

Krannert Graduate Sch. of Mgmt., Credit Research Ctr., Monograph No. 4, 1977). Other research on finance companies is beginning to emerge. See Thomas A. Durkin, Gregory Elliehausen & Min Hwang, *Rate Ceilings and the Distribution of Small Dollar Installment Loans from Consumer Finance Companies: Results of a New Survey of Small Dollar Cash Lenders*, (Working Paper, 2014), <http://ssrn.com/abstract=2533143>; Onymbe (Ben) Lukongo & Thomas W. Miller, Jr., *The Consequences of the Constitutional Interest Rate Cap in the State of Arkansas* (Mississippi State University Working Paper, 2015).

⁵ Annamaria Lusardi, Daniel Schneider & Peter Tufano, *Financially Fragile Households: Evidence and Implications*, BROOKINGS PAPERS ON ECONOMIC ACTIVITY 83-150 (Spring 2011).

⁶ TODD ZYWICKI & GABRIEL OKOLSKI, GEORGE MASON UNIV., MERCATUS CTR., MERCATUS ON POLICY NO. 62, POTENTIAL RESTRICTIONS ON TITLE LENDING (2009), available at <http://mercatus.org/publication/potential-restrictions-title-lending>.

⁷ Kathryn Fritzdixon, Jim Hawkins & Paige Marta Skiba, *Dude, Where's My Car Title?: The Law, Behavior, and Economics of Title Lending Markets*, 2014 U. ILL. L. REV. 1013, 1054 (2014).

nities with payday lenders show greater resiliency to natural disasters,” and her estimates of welfare measures “suggest that payday lending enhances the welfare of communities.”⁸

Durkin and McAlister (1971) surveyed borrowers in Texas. Their study is perhaps the last comprehensive study published on the installment lending industry. In their study, Durkin and McAlister (1971) report that 84.2 percent of their respondents answered “Yes” when asked whether the loan was worth it. As a result, another research motivation is to seek current evidence on how consumers respond when asked two underexplored questions: 1) “Would you say you know how to obtain a loan that best suits your needs?” and 2) “Would you say you understand the terms of loans you have taken out?”⁹

The research method used in this study is a telephone survey resulting in a random sample of 400 Mississippians. Whether survey respondents have a bank account, as well as their income and education level, are related to the answers to these two questions.

In the sample of consumers surveyed, 65.5 percent of the Respondents said they agree or strongly agree that they knew where to obtain a loan that suits their needs, while 17.8 percent said they disagree or strongly disagree. Regarding loan terms, 71.3 percent of the Respondents said that agree or strongly agree that they understood the terms of their loans, while 12.8 percent said they disagree or strongly disagree.

Of course, one cannot definitively conclude that consumers truly know where to obtain loans that suit their needs or that they truly understand to terms of the loans they have taken out. Survey results, however, are widely used to help shape public policy and help companies make decisions concerning consumer products. One has no reason to believe that the difference between what consumers say they know and what they actually know is significantly wider in the area of consumer credit than it is in other surveyed areas.

Few would disagree that most borrowers in the non-bank supplied credit space understand that they have to pay back their loans in a timely fashion. In addition, as detailed in Appendix A to this article, non-bank supplied consumer credit products do not have complicated terms.¹⁰

⁸ Adair Morse, *Payday Lenders: Heroes or Villains?*, 102 J. FIN. ECON. 28 (2011), available at http://faculty.haas.berkeley.edu/morse/research/papers/morsepayday_jfe2.pdf.

⁹ The exact wording of the survey questions is: 1) “On a scale of one to five, with “1” being “strongly disagree” and “5” being “strongly agree,” would you say you know how to obtain a loan that best suits your needs?” 2) “On a scale of one to five, with “1” being “strongly disagree” and “5” being “strongly agree, would you say you understand the terms of loans you have taken out?”

¹⁰ Taking on debt has consequences. The survey, however, did not ask consumers whether they understood, or could forecast, the consequences of adding additional debt to their balance sheet. Respondents could very well understand the terms of their loans, but not be able to forecast the consequences of additional debt.

Some consumers have the option to use personal savings instead of small dollar loans to meet unexpected bills or emergency needs for cash. The survey asks Respondents to disclose their actual, and intended, savings habits. Some relevant information gathered by the survey was whether Respondents had a bank account, their income, and their education level. Perhaps not surprisingly, Banked Respondents saved at a higher rate than the Unbanked. Evidence presented in this research shows that Unbanked Respondents tend to be the users of payday loans, title loans, and pawn loans. The survey responses show that income level and the likelihood of having a bank account are related, as are income level and the type of credit product employed.

Concerning the question of whether people know where to go to get a loan that suits their needs, two factors matter, statistically speaking. Whether the Respondent has a bank account or not matters, and so does whether their education level stops at high school. Statistically, however, one cannot be sure that the results hold across all levels of agreement from “strongly disagree” to “strongly agree.”

Concerning the question of whether people understand the terms of their loans, the only factor that matters statistically is whether the educational level of the Respondent stops at high school. Whether they have a bank account or not does not matter, statistically speaking. Statistical tests show that one cannot reject the assumption that these results hold across all levels of agreement: from “strongly disagree” to “strongly agree.”

The paper proceeds as follows. Section I is a narrative of the demand and supply conditions that existed for non-bank supplied consumer credit in the state of Mississippi at the end of 2011—the time of the Survey. Section II contains a description of the survey method used in the study. Section III contains the survey responses, while Section IV presents results from an ordered logit regression. Section V is a summary.

I. DEMAND AND SUPPLY CONDITIONS FOR NON-BANK SUPPLIED CONSUMER CREDIT IN MISSISSIPPI

A. Factors Behind the Demand for Non-Bank Consumer Credit in Mississippi

The economic conditions of the state of Mississippi make the state a natural laboratory to research many policy questions concerning unbanked consumers, non-bank supplied credit products, and the financial condition of lower-income citizens. According to information from various U.S. cen-

sus documents,¹¹ Mississippi ranks significantly below the median in the United States in terms of many wealth, income, and education measures. As a result, it is likely that the demand for non-bank supplied consumer credit is higher in Mississippi than it is in most states.

1. Home Values and Home Ownership Percentages

In 2009, the median home value in Mississippi, \$97,300, was about half that of the U.S. median home value, \$191,900. The median home value in Mississippi ranked 49th of the 50 states, between Arkansas (\$102,900) and West Virginia (\$95,400). Mississippi, however, ranked 14th in the U.S. in terms of household home ownership percentage. For the U.S., 66.4 percent of households were homeowners. For Mississippi, this percentage was 70.1.

2. Income

In 2009, near the time of the Survey, per capita and median household income levels in Mississippi were about three-fourths the national levels. For Mississippi, per capita income¹² was \$30,399 (rank 50th), while for the U.S. per capita income was \$40,208. The median household income in Mississippi was \$36,646 (rank 50th) while the median household income was \$50,221 for the U.S. The percent of households in Mississippi that had an annual income under \$25,000 was 36 percent (rank 50th). By comparison, 24.7 percent of households in the U.S. had annual income less than \$25,000.

3. Education

In 2009, Mississippians held Bachelor's degrees or higher at about two-thirds the average rate in the U.S. In Mississippi, 19.6 percent of the population over the age of 25 held a four year college degree or higher. Mississippi ranked 48th of the 50 states, between Kentucky (21.0 percent) and Arkansas (18.9 percent). By comparison, for the U.S., 27.9 percent of the population over the age of 25 held a four-year college degree or higher.

¹¹ U.S. CENSUS BUREAU, <http://www.census.gov> (last visited June 22, 2015); U.S. CENSUS BUREAU, STATE & COUNTY QUICKFACTS, <http://quickfacts.census.gov> (last visited June 22, 2015).

¹² Per capita personal income is total personal income divided by total midyear population.

B. *Supply of Non-bank Consumer Credit in Mississippi*

Four major non-bank consumer credit products exist in the state of Mississippi: 1) Payday Loans; 2) Vehicle Title Loans; 3) Pawn Loans, and; 4) Traditional Installment Loans from finance companies.¹³

Table A2 in Appendix A contains a summary of the loan terms of these loan products in Mississippi.¹⁴ For example, in 2011, there were 1,053 licensed check cashers (a category that includes payday lenders). Given the estimated 2011 state population, there was a licensed check casher or payday lender for every 2,100 Mississippians over the age of 18.¹⁵ There were 525 licensed “small” loan companies (“Small Loan”), whose main lending product is a personal installment loan. The total outstanding loan balance for the Small Loan category suggests that there was an average loan balance of about \$2,450.¹⁶ Additionally, there were 219 licensed pawnbrokers, and 402 licensed title pledge lenders.

Dividing the dollar amount of the loans outstanding by the number of licenses outstanding yields a snapshot estimate of the average loan capital required per each licensee. For check casher / payday loans, this amount is \$43,409—the smallest capitalization of the four types of consumer loan products. Pawnbroker and title pledge lender capital amounts are \$46,891 and \$76,730, respectively. In stark contrast to these levels, the Small Loan category has a loan capital estimate of \$1,530,045 per licensee. This amount is about twenty times the level of the average title pledge and about 35 times the level of the average check casher/payday lender. These contrasting levels suggest that the fundamental business model of making small dollar traditional installment loans differs significantly from the business models of the other three categories of consumer loan choices.

II. SURVEY METHOD

In December 2011, *The Survey Research Laboratory* at Mississippi State University conducted a statewide telephone survey at the request of *Economy Watch*, a now defunct publication of the College of Business at Mississippi State University. In addition to the questions asked for the

¹³ A description of these loan products and their terms for Mississippians appears in Appendix A.

¹⁴ See also THERESA L. BRADY, MISS. DEP'T OF BANKING AND CONSUMER FIN. ANNUAL REPORT JAN. 1, 2011 – DEC. 31, 2011, <http://www.dbcf.state.ms.us/documents/annual-report11.pdf>.

¹⁵ In 2011, the Census estimates the total population of Mississippi to be 2,967,299, with 24.7% under the age of 18.

¹⁶ This loan category represents a mature industry that contains loans that exceed twelve months in duration. One can assume, therefore, an approximate steady state as consumers pay off old loans and take out new ones. In this case, the dollar amount outstanding will be roughly stable, as will be the number of transactions.

Economy Watch article, the survey included a set of questions concerning the use of consumer credit products.¹⁷ The Center for Disease Control and Prevention's National Center for Health Statistics reported that, in 2007, 19.1 percent of adults in Mississippi lived in households using only wireless phones.¹⁸ For this survey, *The Survey Research Laboratory* formed a random sample consisting of 25 percent wireless phone numbers and 75 percent landline phone numbers. Interviewers called 9,500 numbers to get 400 people to answer the 32-question survey (hereinafter "Respondents").

Consistent with standard survey research practice, the responses were weighted by gender, race, and age so that the responses mirror prior knowledge about gender, race, and age distribution in the state.¹⁹ As a result of weighting the observations, the sampling error (for dichotomous response options with a 50/50 split) is no larger than ± 5 percent at a 95 percent confidence level.

III. SURVEY RESULTS

A. *Savings Habits and Plans*

One way for consumers to finance unexpected expenses is to have a "rainy day fund." Consumers undoubtedly know that, to the extent that

¹⁷ No results presented in the current study appear in *Economy Watch*. The answers to the survey questions that appear in *Economy Watch* were about questions like: the general economic conditions in the State of Mississippi, whether the Respondents felt their families were better off now than one year ago, and whether it is a good time to purchase consumer durables.

¹⁸ See STEPHEN J. BLUMBERG ET AL., U.S. DEP'T OF HEALTH & HUMAN SERVS., CTRS. FOR DISEASE CONTROL & PREVENTION, NAT'L CTR. FOR HEALTH STATISTICS, NAT'L HEALTH STATISTICS REP. NO. 14, WIRELESS SUBSTITUTION: STATE-LEVEL ESTIMATES FROM THE NATIONAL HEALTH INTERVIEW SURVEY, JANUARY–DECEMBER 2007 (2009). The 2013 version of the report from the National Center for Health Statistics reports that 49 percent of adults in Mississippi live in households that only use wireless phones. See STEPHEN J. BLUMBERG ET AL., U.S. DEP'T OF HEALTH & HUMAN SERVS., CTRS. FOR DISEASE CONTROL & PREVENTION, NAT'L CTR. FOR HEALTH STATISTICS, NAT'L HEALTH STATISTICS REP. NO. 70, WIRELESS SUBSTITUTION: STATE-LEVEL ESTIMATES FROM THE NATIONAL HEALTH INTERVIEW SURVEY, 2012 (2013). A sampling vendor sold phone numbers to the *Survey Research Laboratory* and made a recommendation about the proportion of wireless phone numbers to use. While providing the best estimate at the time, the vendor likely underestimated the penetration rate of wireless phones by 2011. The direction of the bias, if any, introduced is unknown because the relationship between wireless phone use and the use of non-bank supplied credit is unknown.

¹⁹ Each survey response receives a weight based on gender, race, and age. The weighting scheme works like this. Suppose the Respondent is a black female in the 18-24 age group. To calculate the weight for this Respondent, one divides the percent of the population in Mississippi that black females age 18-24 represent by the corresponding percent in the sample. The weight will be greater than one if too few Respondents in the sample are from this category, and will be less than one if there are too many. Similar weights are calculated for black males, white males, and white females for this age group as well as three others: 25-44, 45-64, and 65+.

they have saved some money, they can use this money to pay for unexpected financial shocks. Despite the wish by most observers that all households have emergency savings, many consumers do not have such savings.²⁰

One goal of this part of the paper is to document savings habits and plans by Respondents in the survey. A further goal is to document whether these habits and plans vary by whether anyone in the Respondent's household (including the Respondent) has a checking or savings account at a bank.

Table 1 and Figures 1a and 1b present survey results concerning savings habits and planned saving. About half of all Respondents reported that they were able to save money last year, while eighty percent say that they plan to save money in the coming year. This finding almost certainly represents a "triumph of hope over experience." That is, there is no reason to believe, *ex ante*, that 2011 was significantly different from 2010. If so, it is likely that in 2010 half the Respondents would have reported that they saved in 2010, and eighty percent likely planned to save in 2011. Only half of them, however, did save in 2011.

Conditional on saving in 2011, about 95 percent of the Respondents stated that they intended to save in 2012. This percentage is most likely a reasonable estimate, because this group of consumers had displayed savings behavior. Note, however, that 65 percent of the Respondents who did not save in 2011 stated that they intend to save in 2012.²¹

Table 3 and Figures 1b and 1c separate the Respondents into those who affirmed that someone in their household (including themselves) has a checking or savings account at a bank (hereinafter "Banked Respondents") from those who did not. In the Survey, 15.8 percent of the Respondents said that no one in their family had a bank account (hereinafter "Unbanked Respondents"). This level is consistent with a recent study by the Federal Deposit Insurance Corporation (FDIC) that reports 15.1 percent of citizens in Mississippi are unbanked.²²

About 55 percent of the Banked Respondents reported that they saved money in the previous year, compared to about 33 percent of the Unbanked Respondents. These two proportions are statistically significantly different,

²⁰ For example, Grinstein-Weiss, Russell, Tucker, and Comer recommend that policy makers should explore opportunities to facilitate and fund "innovative collaborations between academic, research, business, and government partners [to] generate new approaches to long-standing problems (e.g., lack of emergency savings) and provide effective interventions that can significantly improve the financial well-being of American households." MICHAL GRINSTEIN-WEISS ET AL., WASHINGTON UNIV. IN ST. LOUIS, CTR. FOR SOC. DEV., POLICY BRIEF NO. 14-13 LACK OF EMERGENCY SAVINGS PUTS AMERICAN HOUSEHOLDS AT RISK: EVIDENCE FROM THE REFUND TO SAVINGS INITIATIVE (2014).

²¹ Note that the weighting scheme employed introduces rounding error. One can see an example of this rounding error in Table 3. The number of people planning to save is 318, but in the panel directly below, $191 + 126 = 317$.

²² SUSAN BURHOUSE & YAZMIN OSAKI, FED. DEPOSIT INS. CORP., 2011 FDIC NATIONAL SURVEY OF UNBANKED AND UNDERBANKED HOUSEHOLDS 126 (2012).

with a p-value of 0.0021. That is, the percentage of Banked Respondents who reported that they saved is, statistically speaking, a higher percentage of than the Unbanked Respondents who reported that they saved.

Nearly 82 percent of Banked Respondents reported that they planned to save the next year. About 70 percent of Unbanked Respondents also reported that they planned to save the next year. The survey did not attempt to discover which financial service, if any, the Unbanked group will use in their planned saving. These two percentages are not statistically significantly different. A Respondent's answer to the question of whether they planned to save next year does not matter, statistically speaking, whether the Respondent was Banked or Unbanked.

Lusardi, Schneider, and Tufano examine the ability of American households to come up with \$2,000 within 30 days to help weather a financial shock.²³ They document that approximately one-half of American household certainly could not or probably could not do so. The savings situation is likely no better in Mississippi.

Although not reported in a table, the 202 Respondents who said they saved said they saved at the following amounts per month. Twenty-four Respondents said they had saved less than \$50 per month, thirty-nine between \$50 and \$100, thirty-four between \$100 and \$200, thirty-three between \$200 and \$500, forty-one over \$500, and thirty-one refused to answer, did not know, or were not sure. If one assumes that each group saved at the maximum level of their bracket, 31.2 percent of the Respondents did not save a monthly amount needed to accumulate \$2,000 of annual savings. Adding to these sixty-three Respondents the 198 who said they did not save results in 65.3 percent (261/400) of the Respondents who likely did not accumulate \$2,000 in savings in the year before the survey.²⁴

B. *Credit Products Used by Respondents*

1. Results by Bank Account

Table 2 and Figure 2 present Survey results concerning the use of loan products by Respondents. Respondents could state that they use one or more of these products. The results are presented for two groups: the Banked or Unbanked.

Table 2 contains results for financing sources whose main product can be classified as a non-installment loan: 1) Payday Lender; 2) Vehicle Title

²³ See Lusardi, Schneider & Tufano, *supra* note 5.

²⁴ It is possible, of course, that some of these Respondents have accumulated savings of \$2,000 or more.

Lender, and; 3) Pawn Shop. Table 2 also contains results for the loan source whose main loan product is a traditional installment loan.

For each non-installment product listed in Table 2, the “Percent Yes on Product” from Unbanked Respondents exceeds the “Percent Yes on Product” from Banked Respondents. Further, a Chi-Square test for equal percentages shows that these percentages are not statistically equal.

By way of contrast, for traditional installment loans, the “Percent Yes on Product” from Banked Respondents exceeds the “Percent Yes on Product” from Unbanked Respondents. For Finance Companies, the Chi-Square test for equal percentages shows that the null hypothesis of equal percentages is rejected at the 0.0700 level.

Based on the statistical results shown in Table 2, Unbanked Respondents used non-installment loan products at a higher rate than did Banked Respondents. In addition, Unbanked Respondents used installment loan products at a lower rate than did Banked Respondents. Figure 2 displays the contrasting responses for “Percent Yes on Product” by loan source.

2. Evidence Concerning Debt-Trap Avoidance

A current concern of many regulators, lawmakers, and consumer advocates is the so-called “debt-trap.” A “debt-trap” commonly refers to the events that take place when the consumer takes out a short-term lump sum loan and is unable to pay back the interest and principal when they are due. If so, the consumer likely pays only the interest expense, and “rolls over” the principal. If this cycle continues, the borrower can wind up paying a considerable amount of additional interest.

In the media, payday loans are the product most often associated with a cycle of debt. As shown in Table 2, however, Respondents used payday Loans the least of any product. Although payday loans are perhaps the easiest type of loan to obtain, only ten Respondents of 400 reported that they had used the service of a payday lender in the past two years.

Moreover, data in Table 2 shows that Respondents use products that will not trap them in the so-called “debt-trap” more often than they use products that have the potential to do so. Compared to payday loan usage, about three times as many Respondents used vehicle title loans and/or pawn loans. The terms of these agreements are non-recourse. That is, these agreements do not obligate the consumer to repay any money to the vehicle title or pawn lender. The consumer can simply leave their collateral with the lender and keep the proceeds.²⁵

Another way to avoid a cycle of debt is to borrow money using an installment loan. In an installment loan transaction, the borrower and lender

²⁵ Appendix A contains more detail about each of the products that appear in Panel A of Table 4, along with a description of the workings of a small-dollar installment loan.

review the financial condition of the borrower before the lender extends the loan. After agreeing on the terms, the consumer has a known, and fixed monthly payment comprised of interest and principal. As shown in Table 2, many more Respondents used the services of Finance Companies, whose product is a traditional installment loan, than any product from non-installment lenders.²⁶

Overall, as noted above, the Respondents used payday loans least often. As detailed in Appendix A, for the products listed in Table 2, payday loans have the highest allowable interest rate in Mississippi. Pawnshops and title lenders have a lower allowable interest rate, and Respondents used them more often than payday loans. Finance Companies have an even lower allowable rate, and Respondents used them more often than pawnshop and title loans. Respondents, by their revealed choices, seem to try to avoid using a product that could entangle them in a debt trap. Respondents most often chose credit products that were either non-recourse or gave them a clear pathway out of debt.

3. Results by Income

Figure 3 displays the percent of Respondents answering “Yes” to whether they used a particular financial product within the past two years. The results are shown by income level. One thing to note, however, is that 91 of the 400 (22.8 percent) Respondents refused to disclose their income. Another thing to note is that in Figure 3, a “flat spot” indicates a response of zero. For comparison, the use of traditional banks also appears in Figure 3. All income levels reported using the services of a bank. All but one income level, those with income exceeding \$150,000, reported using the services of finance companies offering traditional installment loans.

Recall that the median household income in Mississippi in 2011 was about \$35,000 per year. Figure 3 shows graphically that the loan product usage of those Respondents who reported their income as under \$35,000 differed from that of Respondents who reported their income as \$35,000 and higher. Respondents with income less than \$35,000 were the only ones using payday lenders, and were the majority of the users of Vehicle Title Lenders and Pawnshops.

C. Do Respondents Know Where to get Loans that Suit Their Needs?

The precise wording of the question on the survey was: “On a scale of one to five, with ‘1’ being ‘strongly disagree’ and ‘5’ being ‘strongly

²⁶ Although not reported in Table 2, Respondents used the services of Credit Unions and Banks even more often than they used Finance Companies.

agree,' would you say you know how to obtain a loan that best suits your needs?" Table 3 shows the Likert scale responses for this question. It is common when reporting differences in Likert scale responses to add together the number of responses from the highest possible category and the number of responses in the second highest possible category. Similarly, it is common to add the number in the lowest possible response category to the number of responses in the second lowest possible category. The subsequent discussions call these summed categories "Agree" and "Disagree," respectively.

When looking at all responses, most Respondents answered that they know where to obtain a loan that suits their needs: more than 65 percent agreed, while 17.8 percent disagreed. About 3.7 times as many Respondents agreed than disagreed.

1. Responses by Bank Account

When Respondents are divided by whether they have a bank account, the results differ substantially. The results for Banked Respondents largely agree with the overall results; 69.8 percent of Banked Respondents agreed with the statement that they knew where to get a loan, while 18.1 percent disagreed, a statistically significant difference.

For the Unbanked Respondents, 48.4 percent agreed that they knew where to get a loan, while 37.1 percent disagreed. These percentages for Unbanked Respondents are statistically insignificant. That is, Respondents without a bank account were statistically equally likely to agree or disagree with the statement that they knew where to get a loan that suits their needs.

2. Responses by Income

When separating the Respondents by whether they report income at a higher or lower level than the median for the state of Mississippi, the results are similar to the bank account results above. There is a confounding factor, however, when dealing with these income results. About 22.8 percent of the Respondents refused to answer the question about their income level.

For Respondents who reported income over \$35,000 per year, 81.8 percent of them agreed with the statement that they knew where to get a loan, while 5.3 percent disagreed. For the Respondents with a reported income less than \$35,000 per year, 60.9 percent of them agreed that they knew where to get a loan, while 25.0 percent disagreed. These percentages are statistically significantly different.

3. Responses by Education Level

For purposes of the survey, there are three categories of education. Category one includes Respondents whose maximum formal education is a high school diploma (“Category One”). In the survey, 171 Respondents fit into this category. Category two includes Respondents whose maximum education lies beyond a high school diploma, but not beyond an undergraduate degree (“Category Two”). There were 179 Respondents in this category. Category three includes Respondents whose maximum formal education ended with a degree higher than an undergraduate degree (“Category Three”). This category includes master’s degrees, law degrees, medical degrees, and doctorates of various kinds. There were 46 Respondents in this category. In stark contrast to their refusal to disclose their income, only four of 400 Respondents refused to answer the question about the level of their education.

As shown in Table 3, the level of disagreement strictly fell and the level of agreement strictly rose with the level of formal education. For example, those who disagreed (answer 1 plus answer 2 on the Likert scale) with the statement that they knew where to get a loan were 26.3 percent for Category One, 12.8 percent for Category Two, and 0.0 percent for Category Three. Those who agreed (answer 4 plus answer 5 on the Likert scale) were 55.6 percent for Category One, 70.4 percent for Category Two, and 91.3 percent for Category Three.

D. Do Respondents Understand the Terms of Loans They Have Taken Out?

The precise wording of the question on the survey was: “On a scale of one to five, with ‘1’ being ‘strongly disagree’ and ‘5’ being ‘strongly agree,’ would you say you understand the terms of loans you have taken out?” Table 4 contains the results.

When looking at all responses, when Respondents were asked whether they understood the terms of the loans that they had taken out, more than 70 percent of the Respondents agreed, while 12.8 percent disagreed. About 5.5 times as many Respondents agreed than disagreed when asked whether they understand their loan terms.

1. Responses by Bank Account

When we separate the Respondents by whether they have a bank account, the results for this question are similar. For Banked Respondents, 74.8 percent agreed with the statement that they understood the loan terms, while 8.7 percent disagreed. For Unbanked Respondents, 62.9 percent

agreed that they knew where to get a loan, while 27.4 percent disagreed. In both cases, these percentages are statistically significantly different.

2. Responses by Income

When we separate the Respondents by whether they report income at a higher or lower level than the median for the state of Mississippi, the results are similar to the bank account results for this question. Once again, there is a confounding factor, however, when dealing with these income results. About 22.8 percent of the Respondents refused to answer the question about their income level.

For Respondents who reported income over \$35,000 per year, 86.4 percent agreed with the statement that they understood the loan terms, while 5.3 percent disagreed. For the Respondents who reported income of less than \$35,000 per year, 69.9 percent of them agreed that they understood the loan terms, while 17.3 percent disagreed. In both cases, these percentages are statistically significantly different.

3. Responses by Education Level

When one separates the Respondents by level of education, one sees a similar result for both questions. Recall, as discussed above, that there are three categories of education. As shown in Table 4, the level of disagreement strictly fell and the level of agreement strictly rose with the level of formal education. For example, those who disagreed (answer 1 plus answer 2 on the Likert scale) with the statement that they understood the terms of the loan were 18.7 percent for Category One, 7.8 percent for Category Two, and 2.2 percent for Category Three. Those who Agreed (answer 4 plus answer 5 on the Likert scale) with the statement that they understood the terms of the loan were 63.2 percent for Category One, 77.1 percent for Category Two, and 84.8 percent for Category Three.

IV. ORDERED LOGIT REGRESSION RESULTS

The Survey asks two previously underexplored questions: 1) Do consumers know where to go to get a loan that suits their needs? and 2) Do consumers understand the terms of their loans? The Respondents answered these two questions on a five-point Likert scale: Strongly Disagree, Disagree, Neutral, Agree, and Strongly Agree. Modeling how Respondents agree or disagree to these questions using the combined effects of income, education level, and being banked can lead to a richer understanding for policy makers about these relationships.

In the empirical analysis below, the focus is on the effects of whether Respondents have bank accounts and their maximum education level. The effect of income is not analyzed directly. Too few Respondents chose to disclose their income. While nearly one fourth of Respondents refused to disclose their income level, only one percent refused to disclose their educational level. Because income and education are highly correlated, excluding income in multivariate analysis will not likely bias the statistical inferences and conjectures about economic significance.

A. *Cumulative Distributions of Actual Survey Responses*

Table 5 contains the actual cumulative percentages from Respondents to the two questions of interest. The cumulative percentages reflect only: 1) whether the Respondent had a bank account or not, OR 2) whether the Respondent had a high school education or beyond. That is, the results immediately below do not reflect a combination of the two factors. There are some notable differences in the cumulative percentages.

1. Obtaining a Loan

Panel A of Table 5 contains the results for the question, “Would you Say You Know How to Obtain a Loan that Suits Your Needs? Look at the entry for “Disagree.” This entry represents the percentage of Respondents who answered strongly disagree or disagreed. The cumulative percentages are nearly three times as high for the unbanked versus the banked Respondents. The cumulative percentage of the unbanked Respondents who strongly disagreed or disagreed is 37.1 percent compared to 13.1 percent of the banked who strongly disagreed or disagreed.

Next, look at the entry for “Disagree” in the lower half of Panel A of Table 5. This entry represents the percentage of Respondents who answered strongly disagree or disagreed, split by education level. The cumulative percentage of Respondents with a maximum education level of high school who strongly disagree or disagreed is 26.3 percent, compared to 11.3 percent for the Respondents with a maximum education level of more than high school.

Figures 7a and 7b are graphs of the results presented in Panel A of Table 5. These graphs show that there is more disagreement for the Unbanked Respondents versus the Banked Respondents. One can see that the cumulative percentages for the Unbanked Respondents lie above the cumulative percentages of the Banked Respondents. One can see that the cumulative percentages of those with a maximum high school education lie above those with an education beyond high school. That is, there is more disagreement with the question for those with a lower education level.

2. Understanding Loan Terms

Panel B of Table 5 contains the results for the question, “Would you Say You Understand the Terms of Loans that You Have Taken Out?” Looking at the entry for “Disagree,” the cumulative percentages are more than three times as high for the Unbanked Respondents versus the Banked Respondents. The cumulative percentage of the Unbanked Respondents who strongly disagreed or disagreed is 27.4 percent compared to 8.7 percent of the Banked who strongly disagreed or disagreed. Looking at the entry for “Disagree,” the cumulative percentage of Respondents with a maximum education level of high school who strongly disagree or disagreed is 18.7 percent compared to 7.9 percent for the Respondents with a maximum education level more than high school.

Figures 8a and 8b are graphs of the results presented in Panel B of Table 5. Once again, these graphs show that there is more disagreement for the Unbanked versus the Banked. One can see that the cumulative percentages for the Unbanked lie above the cumulative percentages of the Banked. One can see again that the cumulative percentages of those with a maximum high school education lie above those with an education beyond high school. That is, there is more disagreement with the question for those with a lower education level.

An interesting extension of these univariate results is the question: What happens when both bank account and education level are included to explain the cumulative distribution of Survey responses? Of interest to academics is whether coefficient estimates for these two factors are statistically significant. Of broader interest, especially to policy makers, is whether these observed cumulative percentages are of economic significance.

B. Estimating Cumulative Distributions Jointly using Banked Status and Education Level

Normally, one uses ordinary least squares regression to measure the nature of the relationship between a dependent variable and one or more explanatory variables. When the dependent variable is categorical, however, the use of ordinary least squares regression is not appropriate. A fundamental assumption of ordinary least squares is that researchers measure the dependent variable without error.

Subjective feelings assigned to the outcomes introduces error. Even though one can recast the categorical responses as ordinal, one cannot say that the difference between Strongly Disagree (=1) and Disagree (=2) is the same as the difference between Agree (=4) and Strongly Agree (=5). Differences in the ordinal rankings can differ substantially among Respond-

ents. The regression model commonly used in the case of ordinal dependent variables is the ordered logit, or proportional odds, model.²⁷

C. *Knowing Where to Get a Loan*

1. Statistical Significance

Table 6 contains the ordered logistical regression results for the question, “Would You Say You Know How to Obtain a Loan that Suits Your Needs?” The results of three regressions appear. In Regression (A), the dependent variable is whether the Respondent is Unbanked ($X = 1$) or not ($X = 0$). In Regression (B), the dependent variable is whether the maximum level of education is high school ($X = 1$) or not ($X = 0$). In Regression (C), both independent variables appear. A consistent set of statistical results appears.

The regression coefficients for both variables, entering either alone or together, are statistically significantly negative. The meaning of these negative coefficients is as follows. For Unbanked Respondents, as well as those whose maximum education level is high school, the cumulative percentage of how they agree is lower than it is for Banked Respondents and those whose maximum education level is beyond high school. That is, one would predict that the Unbanked and the high school groups are more likely to disagree with the statement that they know where to go to obtain a loan that suits their needs.

Researchers test how well the specified model explains the observed level of agreement. The null hypothesis that the specified model fits the observed outcomes is rejected by the Pearson Goodness of Fit test for each regression specification. In addition, the level of the Nagelkerke Pseudo R-Square suggests that these models are likely to be a poor predictor of the outcome for any particular Respondent. The low levels of the Pseudo R-Square, however, do not rebut the fact that there is a statistically significant difference between groups of Respondents.

The null hypothesis of the Test of Parallel Lines is that the relationship between the explanatory variables and the logits are the same for all logits. As shown in Table 6, the Test of Parallel Lines rejects this null hypothesis for each regression specification. This fact suggests that one should conduct more analysis if one wants to place more faith in the level of the estimated regression coefficients. Because the current study of these questions is exploratory, such an analysis is left for future researchers.

The results in Table 6 show that a bank account and an education level higher than a high school diploma results in the highest cumulative agree-

²⁷ Appendix B contains some details and further references for this type of regression model.

ment with the question of whether a Respondent knows how to obtain a loan that suits their needs. Moreover, both effects matter when trying to explain the difference in cumulative percentage agreement between sub-groups.

The policy implication is that it is possible that whether the Respondent has a bank account or not relates to how confident they say they are in answering the question that they know where to go to get a loan that suits their needs. This result has some intuitive appeal. To obtain a payday loan, a borrower must have a checking account. To obtain a traditional installment loan, it is likely that the underwriting process will place a higher probability of obtaining a loan if the borrower can write checks to pay the monthly installments. Borrowers without bank accounts, therefore, might well be unsure where to go to obtain loans.²⁸

2. Economic Significance

By estimating the cumulative probabilities for each group, one can predict cumulative probabilities for different groups. One can use the estimated regression coefficients in Table 6 to calculate predicted cumulative predicted probabilities with this equation:

$$Prob(Category) = \frac{1}{1 + e^{-(\alpha_k - X_1\beta_1 - X_2\beta_2)}} \quad (1)$$

The estimated intercept coefficients for Strongly Disagree and Disagree are -2.435 and -1.904, respectively. To start, calculate the predicted cumulative probabilities for those Respondents who are banked and have a maximum education level greater than a high school degree. One does so by applying Equation (1) with $X_1 = 0$ and $X_2 = 0$. For the lowest category, Strongly Disagree, the predicted cumulative probability is:

$$\begin{aligned} Prob(Strongly Disagree) &= \frac{1}{(1 + e^{-(\alpha_k)})} = \frac{1}{(1 + e^{-(-2.435)})} \\ &= 0.0805 \text{ or } 8.1\%. \end{aligned}$$

For the next to lowest category, Disagree, the predicted cumulative probability is:

²⁸ Of course, Vehicle Title and Pawn are still available to these consumers. As described in Appendix A, however, these products are not loans in the traditional sense. Consumers have no obligation to repay the cash proceeds, fees, and interest charges when using these products.

$$\begin{aligned} \text{Prob}(\text{Strongly Disagree or Disagree}) &= \frac{1}{(1 + e^{-(\alpha_k)})} \\ &= \frac{1}{(1 + e^{-(-1.904)})} = 0.1297 \text{ or } 13.0\%. \end{aligned}$$

One can make similar calculations for two other categories, Neutral and Agree. The cumulative probability for Strongly Agree is 1.00, or 100 percent. In Table 6, the line “Banked, Education > High School” contains these predicted cumulative probabilities.

In Table 6, the Unbanked slope coefficient is -0.739 and the slope coefficient for Maximum Education, High School is -0.422. For Respondents who are Unbanked, $X_1 = 1$, and with a Maximum Education, High School, i.e., $X_2 = 1$, the predicted cumulative probability for Strongly Disagree is:

$$\begin{aligned} \text{Prob}(\text{Strongly Disagree}) &= \frac{1}{(1 + e^{-(\alpha_k - \beta_1 - \beta_2)})} \\ &= \frac{1}{(1 + e^{-(-2.435 - (-0.739) - (-0.422))})} \\ &= \frac{1}{(1 + e^{(2.435 - 0.739 - 0.422)})} = 0.2186 \text{ or } 21.9\%. \end{aligned}$$

In Table 6, the line “Unbanked, Education \leq High School” contains the set of cumulative predicted probabilities for this group. In a similar manner, one can calculate cumulative predicted probabilities for the other two groups by using the appropriate intercept and the relevant slope coefficient.

The cumulative predicted probabilities for the “Unbanked, Education \leq High School” group lie above those for the “Banked, Education > High School” group at every category. Looking at the Disagree Category, the cumulative predicted probabilities are 32.2 percent versus 13.0 percent, respectively.

One can also attempt to compare the relative effects of the two independent variables. The bottom four lines in Table 6 present differences in cumulative predicted probabilities. For Banked Respondents, the difference in cumulative probabilities is 5.5 percent (18.5 – 13.0) as education changes. For those with less than a high school education, the difference in probabilities is 13.7 percent (32.2 – 18.5) as banking status changes. By these calculations, banking status is economically more important when explaining how Respondents say they know where to get a loan that suits their needs.

D. *Understanding the Terms of the Loan*

1. Statistical Significance

Table 7 contains the ordered logistical regression results for the question, “Would you Say You Understand the Terms of Loans You Have Taken Out?” The results of three regressions appear. In Regression (A), the dependent variable is whether the Respondent is Unbanked ($X = 1$) or not ($X = 0$). In Regression (B), the dependent variable is whether the maximum level of education is high school ($X = 1$) or not ($X = 0$). In Regression (C), both independent variables appear.

The regression coefficients for both variables, when entering alone, are statistically significantly negative. The meaning of these negative coefficients is as follows. For Unbanked Respondents, as well as those whose maximum education level is high school, the cumulative percentage of how they agree is lower than it is for Banked Respondents and those whose maximum education level is beyond high school. That is, one would predict that the Unbanked and the High School groups are more likely to disagree with the statement that they know where to go to obtain a loan that suits their needs.

Regression (C) includes both explanatory variables. Only the explanatory variable for education level is statistically significantly negative. The inference in this regression is that the cumulative percentage agreement for the group of Respondents who did not study beyond high school is lower than it is for those who did. Moreover, the difference between the cumulative percentages is not predicted to change when one accounts for whether the Respondent has a bank account. Consequently, the statistical conclusion is that only the independent variable for education level is of statistical interest concerning the question of whether Respondents say that they understand the terms of their loans.²⁹

As with the results in Section V.C.1, the level of the Nagelkerke Pseudo R-Square suggests that these models are also likely to be poor predictors of the outcome for any particular Respondent in the Survey. Once again, however, this inference does not rebut the fact that there is a statistically significant difference between groups of Respondents. Statistically speaking, the specified model seemingly fits the observed level of agreement. Using the Pearson Goodness of Fit test, one does not reject the null hypothesis that the specified model fits the observed outcomes for regression specifications (B) and (C).

²⁹ Sometimes, when two independent variables are highly correlated, a researcher can incorrectly judge a variable statistically insignificant when, in fact, it is significant. Evidence against this judgment is that the (unreported) correlation coefficient between the two independent variables is 0.252.

Unlike the results of the regression results presented in Section V.C.1, however, statistical tests do not lead to a rejection of an important ordinal regression assumption when studying this question. The important ordinal regression assumption is that the relationship between the explanatory variables and the logits are the same for all logits. The null hypothesis is that the assumption is valid. The Test of Parallel Lines does not reject this null hypothesis for regression specifications (B) and (C). Practically speaking, this fact suggests that one should have reasonable faith in the level of the estimated regression coefficients.³⁰

Based on the results presented in Table 7, an education level of more than a high school diploma results in a higher cumulative agreement with the question of whether a Respondent understands the terms of their loans. Moreover, whether the Respondent has a bank account does not influence this result.

A possible policy implication from these results, at least in Mississippi, is that efforts in trying to get more people to obtain bank accounts is not likely to affect materially whether borrowers say they understand the terms of loans they take out.

2. Economic Significance

In Table 7, the line “Unbanked, Education \leq High School” contains a set of cumulative predicted probabilities for this group calculated in the manner described in Section V.C.2. In a similar manner, one can calculate cumulative predicted probabilities for the other two groups by using the appropriate intercept and the relevant slope coefficient.

The cumulative predicted probabilities for the “Unbanked, Education \leq High School” group lie above those for the “Banked, Education $>$ High School” group at every category. Looking at the Disagree Category, the cumulative predicted probabilities are 20.3 percent versus 9.5 percent. Both levels are lower, however, for the question about understanding the terms of the loan than they are for the question about knowing where to go get a loan.

One can also attempt to compare the relative effects of the two independent variables. The bottom four lines in Table 7 present differences in cumulative predicted probabilities. For Banked Respondents, the difference

³⁰ As discussed briefly above, an assumption made in the ordinal regression technique is that the odds ratio is equal at each threshold (i.e., at each break point between agreement levels). This assumption stems from the fact that the ordinal model constrains these odds ratios to be equal through the proportional odds assumption. One examines the appropriateness of this assumption by using the Test of Parallel Lines. This test compares the ordinal model that has one set of coefficients for all thresholds to an unconstrained model with a separate set of coefficients. If the unconstrained model yields a significantly better result than the constrained model, then one rejects the assumption of proportional odds.

in cumulative probabilities is 6.2 percent (15.7 – 9.5) as education changes. For those with less than a high school education, the difference in probabilities is 4.5 percent (20.3–5.7) as banking status changes. By these calculations, neither factor seems to be economically more important concerning the question of whether Respondents understand the terms of their loans.

CONCLUSIONS

The area of small dollar credit attracts considerable attention from advocate groups, state legislators, state regulators, and federal regulators. Effective legislation and regulation hinges on the findings of rigorous research. Moving forward, more research on all aspects of small dollar credit markets will provide legislators and regulators with a solid foundation based on findings from scientific research.

Few areas spawn so many emotionally charged opinions and controversy as does the confluence of non-bank supplied credit products and the financial condition of low-income citizens. To add information to the debate, the focus of this paper is on consumer use of non-bank supplied consumer credit products. Specifically, the aim of this research is to document what consumers themselves have to say about which credit products they use.

This paper presents the results of a 2011 survey of a random sample of 400 Mississippians. Consistent with other research, 15.8 percent of the survey Respondents reported that they were unbanked. In the survey, Unbanked Respondents saved at a much lower rate than Banked Respondents.

One possible way for consumers to finance unexpected expenses is to have their own “rainy day fund” that they are willing to use. Based on the survey results, Unbanked consumers would be less likely to have such a cash reserve. All consumers undoubtedly know that to the extent that they have saved some money, they can use this money to pay for unexpected financial shocks instead of borrowing money. As a result, the Unbanked are more likely to use small dollar loans to meet unexpected expenses.

Lusardi, Schneider, and Tufano examine the ability of American households to come up with \$2,000 within 30 days to help weather a financial shock.³¹ They document that about one-half of American household probably could not do so. Based on survey data, approximately 65.3 percent of the Respondents likely did not accumulate \$2,000 in savings in the year before the survey. Of course, even though they saved less than \$2,000 in the previous year, they still could have \$2,000 in savings.

The survey questions center on the use of non-bank supplied consumer credit products. By usage, survey Respondents used payday loans least often. About three times as many Respondents used Title Loans and Pawn

³¹ Lusardi, Schneider & Tufano, *supra* note 5.

Loans—both of which are secured by collateral and are non-recourse. Another way a consumer can avoid being in a cycle of debt is to borrow money using an installment loan. Evidence from the survey shows that many more Respondents used the services of Finance Companies, whose product is an installment loan, than any non-installment loan product. Consumers used the services of credit unions and banks even more than they used Finance Companies.

In the survey, two previously underexplored questions are asked: 1) Do consumers know where to go to get a loan that suits their needs? and 2) Do consumers understand the terms of their loans?

Concerning the question of whether people know where to go to get a loan that suits their needs, two factors matter, statistically speaking. Whether the Respondent has a bank account or not matters, and so does whether their education level stops at high school. Statistically, however, one cannot be sure that the results hold across all levels of agreement from “strongly disagree” to “strongly agree.”

Concerning the question of whether people understand the terms of their loans, the only factor that matters statistically is whether the educational level of the Respondent stops at high school. Whether they have a bank account or not does not matter, statistically speaking. Statistical tests show that one cannot reject the assumption that these results hold across all levels of agreement, from “strongly disagree” to “strongly agree.”

The continued existence of small dollar consumer credit products, despite the ever more restrictive web of regulation, confirms there is a demand for these types of consumer credit. There are many ways for consumers to obtain non-bank supplied credit. These products have starkly different features and clientele. It is incumbent upon anyone who opines about non-bank supplied credit to know these differences. That is, it is imperative to avoid lumping all these products together under the umbrella of “high cost loans” or “small dollar loans.” These credit products differ substantially from one another, just as do other consumer services. Appendix A contains a detailed description of four different small dollar personal loan and financing products.

APPENDIX A. FOUR NON-BANK PROVIDED PERSONAL LOAN CHOICES.

This appendix contains a brief overview of four personal loan and financing products widely available to Mississippi residents at the time of the *2011 Economy Watch Survey*. There are other sources of consumer loans that did not appear in the Survey.³² Some of the products that are available

³² A non-exhaustive list of other loan products includes: Lease to Own Transactions, Bank Deposit Advance Loans, Income Tax Refund Anticipation Loans, Online Payday Loans, Credit Cards (includ-

in Mississippi have been legislated out of existence in certain other states. For example, the constitutional interest rate cap of 17% in Arkansas means that traditional installment loans are unprofitable for lenders. As a result, Arkansas residents who seek an installment loan must travel to a state that borders Arkansas to obtain a traditional installment loan.³³ In addition, payday lending has recently been legislated out of existence in Arkansas.³⁴

A1. Pawnbroker Loans

Durkin, Elliehausen, Staten, and Zywicki state: “Pawnbroker loans are among the oldest forms of credit, stretching back to antiquity.”³⁵ Despite this long history, financial economists have devoted little collective effort to studying the pawn industry and its benefits to consumers. Bos, Carter, and Skiba discuss the handful of academic studies and describe the pawn process in detail.³⁶

In a pawn transaction, the consumer offers a tangible item to the pawnbroker, who pays cash to the consumer and takes possession of the item. Today, the most commonly pawned items are jewelry. Consumer electronic equipment, firearms, tools, and musical instruments are also frequently pawned. The pawnbroker will generally ask whether the consumer wants to sell or pawn the item.³⁷ If the consumer wishes to pawn the item, the parties negotiate the amount that the pawnbroker will “loan” on the item. If there is an agreement, the consumer delivers possession of the item to the pawnbroker, and the pawnbroker gives the agreed upon cash to the consumer and issues a pawn ticket that precisely details the terms of the transaction and cost of redemption.

In a pawn transaction, the consumer does not need to show any proof of income or credit history. The pawnbroker does not report the customer’s performance on the transaction to a credit-reporting agency. A pawn trans-

ing Subprime Credit Cards), Peer-to-Peer Loans, and Installment Loans from Sovereign Nations within the US.

³³ See Durkin, Elliehausen & Hwang, *supra* note 4; Lukongo & Miller, *supra* note 4.

³⁴ See Garry S. Wann & Christi R. Wann, *The History of Payday Lending in Arkansas*, 12 J. ACAD. BUS. & ECON. 167 (2012) (for a history of payday lending in Arkansas), available at <http://www.freepatentsonline.com/article/Journal-Academy-Business-Economics/293812427.html>.

³⁵ THOMAS A. DURKIN ET AL., CONSUMER CREDIT AND THE AMERICAN ECONOMY 353 (2014).

³⁶ Marieke Bos, Susan Payne Carter & Paige Marta Skiba, *The Pawn Industry and Its Customers: The United States and Europe* (Vanderbilt Univ. Law Sch., Law and Econ. Working Paper No. 12-26, 2012), <http://ssrn.com/abstract=2149575>.

³⁷ The pawnbroker will also likely ask how the consumer acquired the item. This question helps the pawnbroker ascertain whether the consumer is the rightful owner of the item.

action is not a loan in the traditional sense because the consumer has no obligation to repay the sum obtained in the pawn transaction. The pawnbroker has no recourse if the customer abandons the pawned item. One can view a pawn transaction, therefore, as a sale with a renewable, month-to-month repurchase agreement.

In the typical pawn transaction, to redeem the pawned item, the consumer must pay various charges for interest, storage, and other fees, in addition to the sum originally advanced by the pawnbroker. The maximum allowable fees vary according to state law.³⁸ In Mississippi, the Pawn Shop Act sets these amounts: “A pawnbroker may contract for and receive a pawnshop charge in lieu of interest or other charges for all services, expenses, cost and losses of every nature not to exceed twenty-five percent (25%) of the principal amount, per month, advanced in the pawn transaction.”³⁹

As an example of a pawn loan, suppose a Mississippian brings a mounted moose head to a pawnshop. The pawn dealer assesses the pawn value of this personal treasure as \$500. If the mounted moose head has considerable sentimental value to the customer, say \$1,000, the customer is likely to redeem the pawn ticket. Assuming maximum allowable charges, at the end of the month the consumer has three choices: 1) abandon the property, 2) extend the pawn another month by paying \$125 (=0.25 times \$500) or, 3) pay \$625 and reclaim the property.

A2. *Payday Loans*

A payday loan is a short-term, lump sum loan. Most of the loans are for a term of 30 days or less. Payday loans are also known as cash advance loans, delayed deposit loans, and deferred presentment loans. In a traditional payday loan, a borrower writes a check to a lender in exchange for a short-term cash loan. The lender agrees not to cash the check until a date specified in the loan agreement.

To obtain a payday loan, lenders generally require borrowers to have an active checking account, provide proof of income, show valid identification, and be at least 18 years old. Payday lenders generally do not require a traditional credit report.

Payday lending exists in most states. As of March 13, 2014, according to the National Conference of State Legislatures, “[t]hirty-eight states have specific statutes that allow for payday lending. Eleven jurisdictions do not have specific payday lending statutory provisions and/or require lenders to

³⁸ See ONLINE PAWN SHOPS CONSUMER REPORTS, STATE PAWN SHOP INTEREST RATES & STATUTES, <http://www.pawnshoponline.info/state-regulation-interest-rates-comparisons/> (for a beginning reference).

³⁹ MISS. CODE ANN. § 75-67-313 (2015).

comply with interest rate caps on consumer loans . . . [while] . . . Arizona and North Carolina allowed pre-existing payday lending statutes to sunset. Arkansas repealed its pre-existing statute in 2011.⁴⁰

Under the *Mississippi Check Cashers Act*,⁴¹ a payday loan agreement must disclose the terms of the loan, including the loan amount and the annual percentage rate (“APR”). The lender will generally require the borrower to write a personal check for the loan principal plus a loan fee, i.e., interest on the loan. The loan agreement might allow the lender to withdraw (or attempt to withdraw) the sum owed from the borrower’s bank account, i.e., cash the check, at the loan due date—regardless of whether the borrower has sufficient funds in the account.⁴² If the borrower does not have sufficient funds, the borrower will be subject to Non-Sufficient Funds (“NSF”) fees charged by their bank.

Under Mississippi law, the largest check a payday loan borrower can write is for \$500. The amount of the check must include the loan principal and allowable fees. For a check written for \$250 or less, Mississippi law allows a payday lender to charge a fee of up to \$20 per \$100 advanced to the borrower.⁴³ For example, if a borrower writes a check for \$240, the lender advances \$200 to the borrower and keeps the check, which includes \$40 in fees. Assuming this loan is for two weeks, the Annual Percentage Rate is: \$40/\$200 times 26 = 520 percent.

A3. Title Loans

A vehicle title loan is similar to a pawn loan, but with an important difference: in a pawn transaction, the consumer gives possession of the item to the pawnbroker; under the terms of a title loan, the borrower retains possession of the pledged collateral. As in a pawn loan, if the borrower defaults on a title loan, ownership of the collateral (the vehicle) is transferred to the lender. Like pawn loans, title loans are non-recourse. If the borrower defaults on the loan, the lender can repossess and begin the process to sell the vehicle. If the vehicle is sold for an amount that is less than the amount owed, the borrower does not have to make up the difference. If,

⁴⁰ NAT’L CONFERENCE OF STATE LEGISLATURES, PAYDAY LENDING STATE STATUTES, <http://www.ncsl.org/research/financial-services-and-commerce/payday-lending-state-statutes.aspx>. See PAYDAY LOAN CONSUMER INFORMATION, LEGAL STATUS OF PAYDAY LOANS BY STATE, <http://www.paydayloaninfo.org/state-information> (for more information on the legal status of payday loans by state).

⁴¹ MISS. CODE ANN. § 75-67-501-37 (2015).

⁴² If the lender deposits the check, but the bank returns it unpaid, the lender can charge only one \$30 NSF fee—and only then if the loan agreement discloses the NSF fee.

⁴³ For checks written for an amount that exceeds \$250 up to \$500, Mississippi law allows a charge of no more than \$21.95 per \$100 advanced to the borrower.

however, the vehicle is sold for more than the outstanding amount owed, the borrower might participate in the excess sale proceeds.⁴⁴

A basic title loan is a non-recourse, one-month lump sum loan with the principal and interest due at the end of the month. If the borrower cannot repay the principal, the title lender can allow an interest-only payment to roll the loan over for another month.

The variety in state laws makes for differences in the title loan transaction.⁴⁵ In Mississippi, “[a] title pledge lender may contract for and receive a title pledge service charge in lieu of interest or other charges for all services, expenses, cost and losses of every nature not to exceed twenty-five percent (25%) of the principal amount, per month, advanced in the title pledge transaction.”⁴⁶ States also regulate the loan amount of in a title loan. In Mississippi, the maximum amount is \$2,500.⁴⁷

The application process for a title loan is straightforward. To secure a title loan, the borrower must have a clear title to the vehicle, and the borrower must allow the title lender to place a lien on the vehicle. According to Hawkins, the borrower might sometimes need to provide references and proof of income.⁴⁸ The borrower does not need to provide a credit history.

Suppose a Mississippian brings a 2003 Chevrolet Tahoe to a title lender. The title lender can inspect the vehicle, if present, and/or look up values for similarly equipped vehicles. Suppose this vehicle has a wholesale appraisal of about \$3,900 and the lender makes a loan of \$2,500. Assuming maximum allowable charges, at the end of the month the Mississippian has three choices: 1) transfer ownership to the title lender, 2) extend the loan for another month by paying the title lender \$625+\$250 (=0.25 times \$2,500, plus a required 10% reduction in the principal), or 3) pay \$3,125 and reclaim the vehicle.

A4. Finance Company Installment Loans

In the early 1900s a battle raged against illegal “loan sharks,” and an alternate new loan source emerged through the collaboration of lenders who wanted to offer this new product and consumer advocates, notably Arthur

⁴⁴ In Mississippi, 85% of the surplus from the sale goes to the borrower. *See* MISS. CODE ANN. § 75-67-411 (2015).

⁴⁵ *See* CTR. FOR RESPONSIBLE LENDING, CAR TITLE LENDING BY STATE, <http://www.responsiblelending.org/other-consumer-loans/car-title-loans/tools-resources/car-title-lending-by-state.html> (for a beginning resource).

⁴⁶ MISS. CODE ANN. § 75-67-413 (2015).

⁴⁷ MISS. CODE ANN. § 75-67-415 (2015).

⁴⁸ Jim Hawkins, *Credit on Wheels: The Law and Business of Auto-Title Lending*, 69 WASH. & LEE L. REV. 535 (2012).

H. Ham of the Russell Sage Foundation.⁴⁹ What emerged was the Universal Small Loan Law written in 1916. By 1940, all but nine states had adopted some version of this proposed law.

The striking feature of this law was that it allowed for interest rates higher than allowed under existing usury laws. Of course, illegal “loan sharks,” and those who favored low interest rate ceilings, lobbied long and hard against this legislation. When collaborating on the Uniform Small Loan Law, the parties agreed: 1) Legal installment lenders must be able to earn a reasonable profit. Therefore, the interest rate was initially set at 3 to 3.5 percent per month; 2) Small loans were defined as “up to \$300” (in today’s dollars, about \$7,137); and 3) The maximum interest rate would be re-examined periodically to sustain the industry.

In Mississippi, the maximum allowable finance charges by licensees operating under the Small Loan Regulatory Law is set by statute.⁵⁰ The maximum interest rate is about the same as that set forth in the Universal Small Loan Law of 1916. For an unpaid balance up to \$1,000, the maximum annual rate is 36 percent (3 percent per month). For amounts over \$1,000 up to \$2,500 the maximum rate is 33 percent; for amounts over \$2,500 to \$5,000 the maximum rate is 24 percent; and for amounts over \$5,000 the maximum allowable annual rate is 14 percent. In addition, a licensee can contract for and charge a closing fee of 4 percent or \$25, whichever is greater, for loans of \$10,000 or less.

As an example of an installment loan, suppose a consumer wants to borrow \$1,000 to pay for vehicle repairs. The terms of the loan are twelve months, an annual interest rate of 36 percent (3 percent per month), and no closing fee (for ease of calculation). To calculate the loan payment, we use the following two equations:

Where:

$$\$P = \$C \left[\frac{1 - \text{Present Value Factor}}{r} \right]$$

$$\text{Present Value Factor} = \frac{1}{(1+r)^T}$$

In this example, the Present Value Factor is .70138. The resulting monthly payment is

$$\$1,000 = \$C \left[\frac{1 - 0.70138}{.03} \right] = \$C[9.9540]$$

⁴⁹ See generally ARTHUR H. HAM, SMALL LOAN LEGISLATION: PROGRESS AND IMPROVEMENT: ADDRESS DELIVERED BEFORE THE SEVENTH ANNUAL CONVENTION OF THE AMERICAN INDUSTRIAL LENDERS’ ASSOCIATION, CHICAGO, SEPTEMBER 23, 1921 (1922), available at <http://memory.loc.gov/service/gdc/scd0001/2010/20100401010sm/20100401010sm.pdf>.

⁵⁰ MISS. CODE ANN. § 75-17-21 (2013).

and we can calculate $SC = \$100.46$. The total of interest and principal payments equals the payment times the number of payments, or $\$100.46$ times 12, or $\$1,205.55$. The consumer borrowed $\$1,000$, so the consumer pays $\$205.55$ in interest over the life of the loan. Notice that the consumer does not pay $\$1000$ times $.36$, or $\$360$ of interest. The difference between $\$360$ and $\$205.55$ occurs because the amount owed each month declines, or amortizes, over the length of the loan. Therefore, even though the 36 percent interest rate determines the size of the installment payment, the interest income received by the lender is $\$205.55$, or 20.56 percent of $\$1,000$.

Table A1. Summary of Four Consumer Credit Products, Mississippi 2011.*Panel A. Loan Descriptions and Terms*

Loan Source	Mainline Consumer Loan Product	Loan Size	Maximum APR and Typical Length
Pawn	Non-Recourse Secured Loans	Depends on Item	300% ; One month, renewable
Payday	Lump Sum Loans--Unsecured	\$200 Minimum	520% ; Two Weeks, can be rolled-over
Title	Non-Recourse Secured Loans	Maximum is \$2,500	300% ; One month
Finance Company	Traditional Installment Loans	Depends on Customer	36% ; 6-24 months

Panel B. Loan Process and Credit Check

Loan Source	Loan Process	Check Credit	Report to Credit Bureau	Can help improve credit score	Can hurt credit score
Pawn	Negotiation about value of item pawned	Minimal	No	N/A	N/A
Payday	Verifiable Income	Minimal	No, prohibited	N/A	N/A
Title	Negotiation, vehicle value; verifiable income	Minimal	No	N/A	N/A
Finance Company	Detailed Underwriting Process	Extensive	Yes	Yes	Yes

Table A2. Summary of Four Consumer Credit Outlets in Mississippi in 2011, by Category

State of Mississippi Category:	Author Description of Loan Product:	Mississippi Licenses as of 12/2011	Transactions	Loans outstanding
Check Cashier/Payday Loan	Lump Sum Short-Term Loans	1,053	180,884	\$45,709,994
Title Pledge	Non-Recourse Secured Loans	402	786,377	\$30,845,280
Pawnbroker	Non-Recourse Secured Loans	219	540,548	\$10,269,227
Small Loan	Traditional Installment Loans	525	327,892	\$803,273,591

Source: Mississippi Department of Banking and Consumer Finance, Annual Report 2011
<http://www.dbef.state.ms.us/documents/annual-report11.pdf>

APPENDIX B. ORDINAL LOGISTIC REGRESSION DETAILS

If the dependent variable had two outcomes instead of several, the familiar logistic regression is appropriate.

$$\ln \left[\frac{p(Y=1)}{1-p(Y=1)} \right] = \alpha + X\beta + \epsilon \quad (A1)$$

In Equation (A1), a quantity known as a logit appears to the left of the equal sign. A logit is simply the log of the odds that an event occurs (i.e., $Y = 1$). The regression model commonly used in the case of ordinal dependent variables is the ordered logit, or proportional odds, model.⁵¹ One can modify the binary logistic regression model in Equation (A1) to incorporate the ordinal nature of the dependent variable (i.e., five categories). This modification defines the probabilities differently. As described by Norušis, instead of considering the probability of $Y = 1$, one considers the probability of that event and all events that are ordered before it.⁵² That is, one has “cumulative” logits, and the logit model becomes:

$$\ln \left[\frac{p(Y \leq k)}{1 - p(Y \leq k)} \right] = \alpha_k - X_1 \beta_1 - X_2 \beta_2 + \epsilon \quad (\text{A2})$$

In Equation (A2), note also that each cumulative logit has its own intercept term but the same slope coefficients. Having the same slope coefficients implies that the independent variables have the same effect across all ordered categories. This testable assumption is why the ordered logit model is also called the proportional odds model. The inverse of the logit function, i.e., Equation (A2), is the logistic function, which is the cumulative distribution function (CDF) of the logistic distribution:

$$F(X) = \frac{1}{1 + e^{-(\alpha_k - X_1 \beta_1 - X_2 \beta_2)}} \quad (\text{A3})$$

Note the minus sign in Equation (A2) instead of the customary plus sign. This specification allows for an intuitive interpretation of the estimated coefficients. In this paper, in Equation (A2), $X_1 = 1$ if the Respondent is Unbanked and zero otherwise. If the Respondent has a maximum education level of high school, $X_2 = 1$ in Equation (A2) and zero otherwise. All else equal, if a slope coefficient is negative, lower values (i.e., tending toward strongly disagree) on the numerically ordered Likert scale are more likely when, say, $X_1 = 1$. If one looks at Figures 7a, 7b, 8a, and 8d, one would predict negative estimated coefficient values for β_1 and β_2 . The estimated coefficients appear in Tables 6 and 7 and are, in fact, negative.

⁵¹ See Marija Norušis, IBM SPSS Statistics 19 Advanced Statistical Procedures Companion (2011) or WILLIAM H. GREENE, *ECONOMETRIC ANALYSIS* (7th ed. 2011) (for a detailed explanation of the statistical nature of this model).

⁵² See Norušis, *supra* note 51.

Table 1. Savings Habits and Savings Plans of Survey Respondents*Panel A. All Respondents.*

	Yes	No	Don't Know/ Not sure/ Refused	Total	
Did you save money last year?		202	196	2	400
Percent (of 400):		50.5%	49.0%	0.5%	
Do you plan to save money next year?		318	65	17	400
Percent (of 400):		79.5%	16.3%	4.3%	

Panel B. Respondents Split by Saving Habit.

You saved money last year:					
Do you plan to save money this year?		191	7	4	202
Percent (of 202):		94.6%	3.5%	2.0%	
You did not save money last year:					
Do you plan to save money this year?		126	58	12	196
Percent (of 196):		64.3%	29.6%	6.1%	

Panel C. Respondents Split By Bank Account

		Does anyone in your household currently have a checking or savings account at a bank?			
		Yes	No	Don't Know / Not Sure / Don't Know/ Total	Total
Did you save money last year?	Yes	174	21	7	202
	No	145	42	9	196
	Don't Know/ Not Sure / Refused	0	0	2	2
					400
Do you plan to save money next year?	Yes	261	44	13	318
	No	49	14	2	65
	Don't Know/ Not Sure / Refused	11	4	2	17
					400

Table 2. Respondent Use of Particular Credit Products

	Lump Sum and Non-Recourse Credit Products:						Traditional Installment Loan:	
	Payday Lender		Title Lender		Pawn Shop		Finance Company	
	Yes	No	Yes	No	Yes	No	Yes	No
With Bank Account	5	291	8	288	12	284	40	256
Percent Yes on Product	1.7%		2.7%		4.1%		13.5%	
Without Bank Account	5	54	7	52	9	50	3	56
Percent Yes on Product	8.5%		11.9%		15.3%		5.1%	

Table 3. Percentages Overall and Percentages by Bank Account, Income, and Education, I.

Would You Say You Know How to Obtain a Loan that Suits Your Needs?

		All Respondents:				
Strongly Disagree	46	11.5%	17.8% Disagree			
2	25	6.3%				
3	40	10.0%				
4	50	12.5%	65.5% Agree			
Strongly Agree	212	53.0%				
DK / NS	26	6.5%				
Refused	1	0.3%				
Total:	400					
		Bank Account:				
		No	Yes			
Strongly Disagree	16	25.8%	26	8.1%		
2	7	11.3%	16	5.0%		
3	7	11.3%	32	10.0%		
4	2	3.2%	48	15.0%		
Strongly Agree	28	45.2%	176	54.8%		
DK / NS	2	3.2%	22	6.9%		
Refused	0	0.0%	1	0.3%		
Total:	62		321			
		Income:				
		< \$35,000	> \$35,000			
Strongly Disagree	28	17.9%	7	5.3%		
2	11	7.1%	0	0.0%		
3	17	10.9%	14	10.6%		
4	16	10.3%	23	17.4%		
Strongly Agree	79	50.6%	85	64.4%		
DK / NS	6	3.8%	2	1.5%		
Refused	0	0.0%	0	0.0%		
Total:	157		131			
		Maximum Education Degree:				
		High School	College	Grad School		
Strongly Disagree	30	17.5%	15	8.4%	0	0.0%
2	15	8.8%	8	4.5%	0	0.0%
3	16	9.4%	24	13.4%	0	0.0%
4	14	8.2%	29	16.2%	8	17.4%
Strongly Agree	81	47.4%	97	54.2%	34	73.9%
DK / NS	14	8.2%	6	3.4%	4	8.7%
Refused	1	0.6%	0	0.0%	0	0.0%
Total:	171		179		46	

Table 4. Percentages Overall and Percentages by Bank Account, Income, and Education, II.

Would You Say You Understand the Terms of Loans You Have Taken Out?

All Respondents:						
Strongly Disagree	33	8.3%	12.8%		Disagree	
2	18	4.5%				
3	35	8.8%				
4	43	10.8%	71.3%		Agree	
Strongly Agree	242	60.5%				
DK / NS	27	6.8%				
Refused	2	0.5%				
Total:	400					
Bank Account:						
		No		Yes		
Strongly Disagree	12	19.4%	17	5.3%		
2	5	8.1%	11	3.4%		
3	2	3.2%	30	9.3%		
4	4	6.5%	39	12.1%		
Strongly Agree	35	56.5%	201	62.6%		
DK / NS	5	8.1%	21	6.5%		
Refused	0	0.0%	1	0.3%		
Total:	63			320		
Income:						
		< \$35,000		> \$35,000		
Strongly Disagree	19	12.2%	6	4.5%		
2	8	5.1%	1	0.8%		
3	13	8.3%	8	6.1%		
4	13	8.3%	23	17.4%		
Strongly Agree	96	61.5%	91	68.9%		
DK / NS	7	4.5%	3	2.3%		
Refused	0	0.0%	0	0.0%		
Total:	156			132		
Maximum Education Degree:						
		High School		College		Grad School
Strongly Disagree	22	12.9%	10	5.6%	0	0.0%
2	10	5.8%	4	2.2%	1	2.2%
3	15	8.8%	19	10.6%	1	2.2%
4	17	9.9%	24	13.4%	2	4.3%
Strongly Agree	91	53.2%	114	63.7%	37	80.4%
DK / NS	15	8.8%	8	4.5%	4	8.7%
Refused	1	0.6%	0	0.0%	0	0.0%
Total:	171			179	45	

**Table 5. Cumulative Percentages
by Bank Account and Education**

Panel A.

*Would you Say You Know How to
Obtain a Loan that Suits Your Needs?*

	Cumulative Percentages:	
	Unbanked	Banked
Strongly Disagree	25.8%	8.1%
Disagree	37.1%	13.1%
Neither	51.6%	30.0%
Agree	54.8%	44.9%
Strongly Agree	100.0%	100.0%

	Cumulative Percentages:	
	Max Ed., High School	Max Ed., > High School
Strongly Disagree	17.5%	7.0%
Disagree	26.3%	11.3%
Neither	44.4%	27.0%
Agree	52.6%	43.0%
Strongly Agree	100.0%	100.0%

Panel B.

*Would You Say You Understand the
Terms of Loans You Have Taken Out?*

	Cumulative Percentages:	
	Unbanked	Banked
Strongly Disagree	19.4%	5.3%
Disagree	27.4%	8.7%
Neither	37.1%	24.5%
Agree	43.6%	36.7%
Strongly Agree	100.0%	100.0%

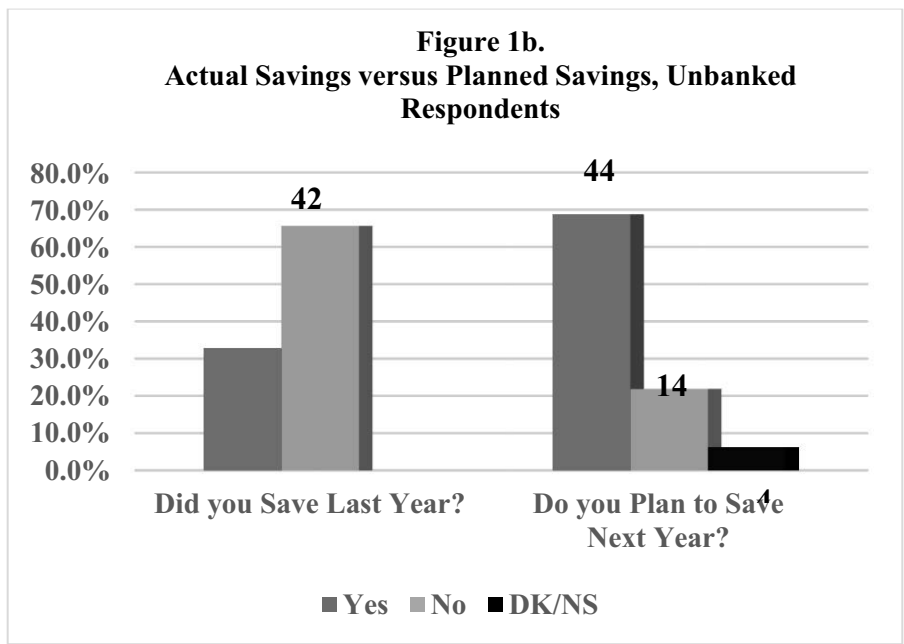
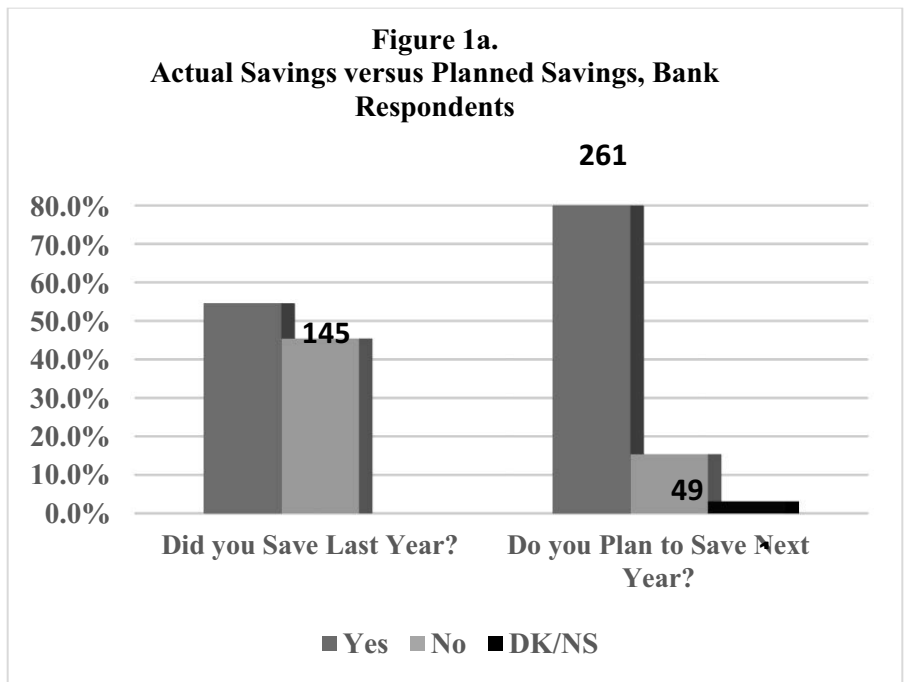
	Cumulative Percentages:	
	Max Ed., High School	Max Ed., > High School
Strongly Disagree	12.9%	4.8%
Disagree	18.7%	7.9%
Neither	36.8%	22.7%
Agree	46.8%	34.1%
Strongly Agree	100.0%	100.0%

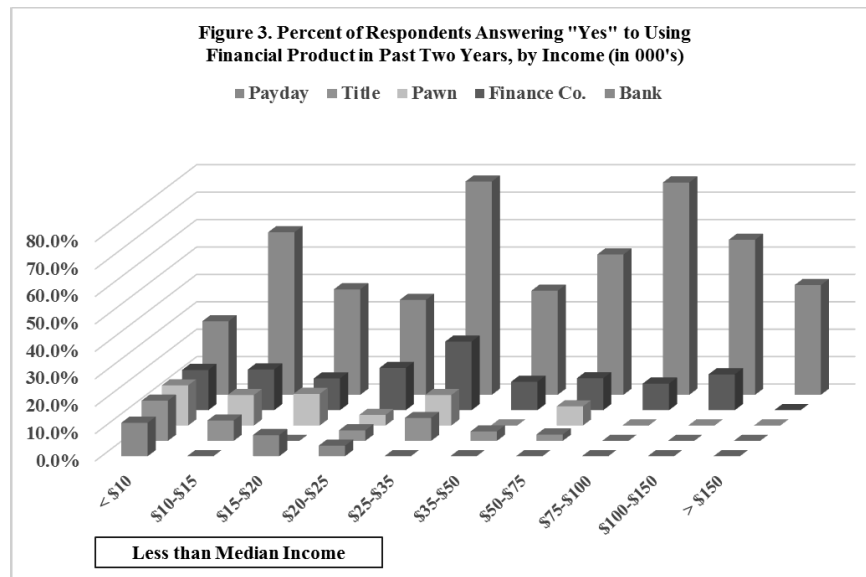
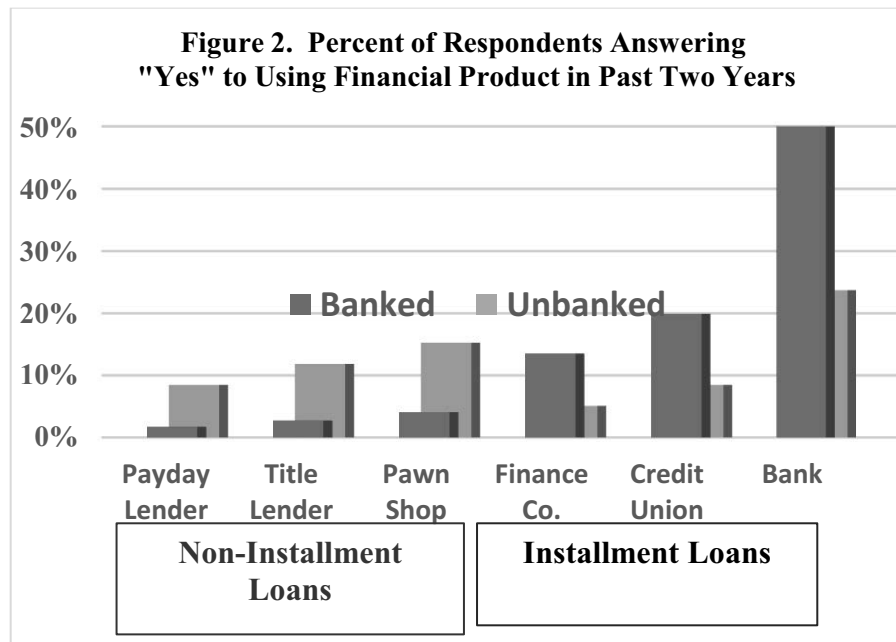
Table 6. Ordered Logit Regression Results, I.
Would You Say You Know How to Obtain a Loan that Suits Your Needs?

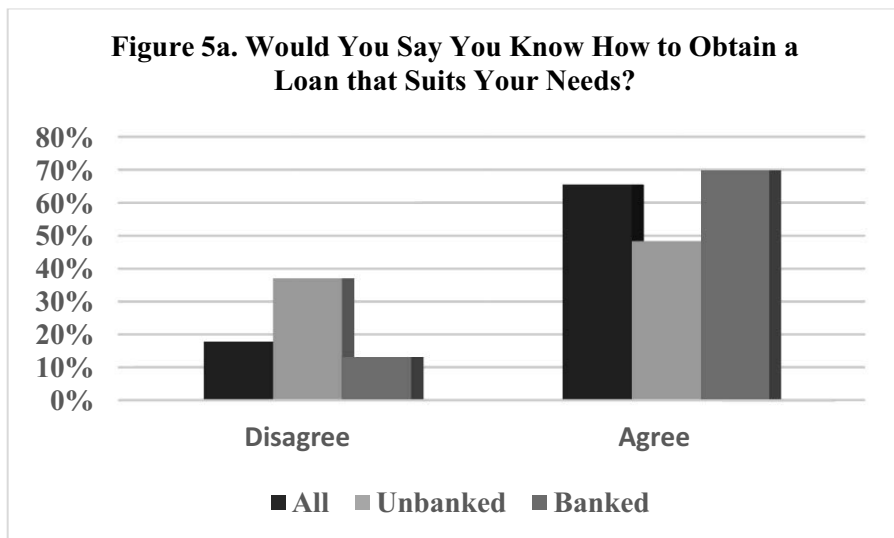
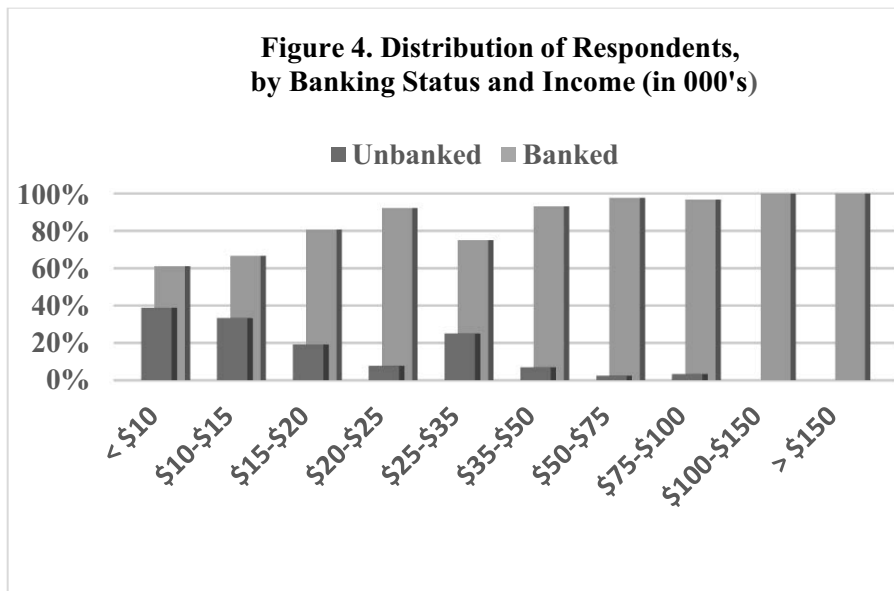
		<u>Regression Specification:</u>				
		(A)	(B)	(C)		
Intercepts:	Strongly Disagree	-2.269	-2.334	-2.435		
	Disagree	-1.744	-1.817	-1.904		
	Neutral	-0.807	-0.894	-0.957		
	Agree	-0.250	-0.361	-0.395		
	Unbanked	-0.866		-0.739		
	Standard Error	0.252		0.261		
	Significance, Wald	0.001		0.005		
	Maximum Education, High School		-0.610	-0.422		
	Standard Error		0.191	0.203		
	Significance, Wald		0.001	0.038		
	Nagelkerke Pseudo R-Square	0.028	0.027	0.042		
	Chi-Square Test of Parallel Lines	12.65	9.87	17.29		
	Significance	0.005	0.020	0.008		
	Pearson Goodness of Fit Test	10.78	9.51	26.87		
	Significance	0.013	0.023	0.003		
<u>Cumulative Predicted Probabilities, Regression (C)</u>						
		Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
Banked, Education > High School		8.1%	13.0%	27.7%	40.3%	100.0%
Banked, Education ≤ High School		11.8%	18.5%	36.9%	50.7%	100.0%
Unbanked, Education > High School		15.5%	23.8%	44.6%	58.5%	100.0%
Unbanked, Education ≤ High School		21.9%	32.2%	55.1%	68.3%	100.0%

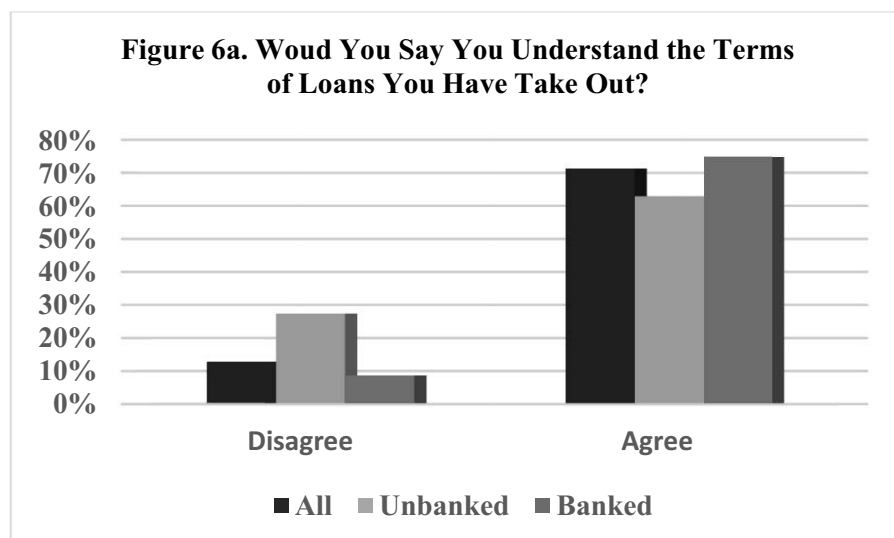
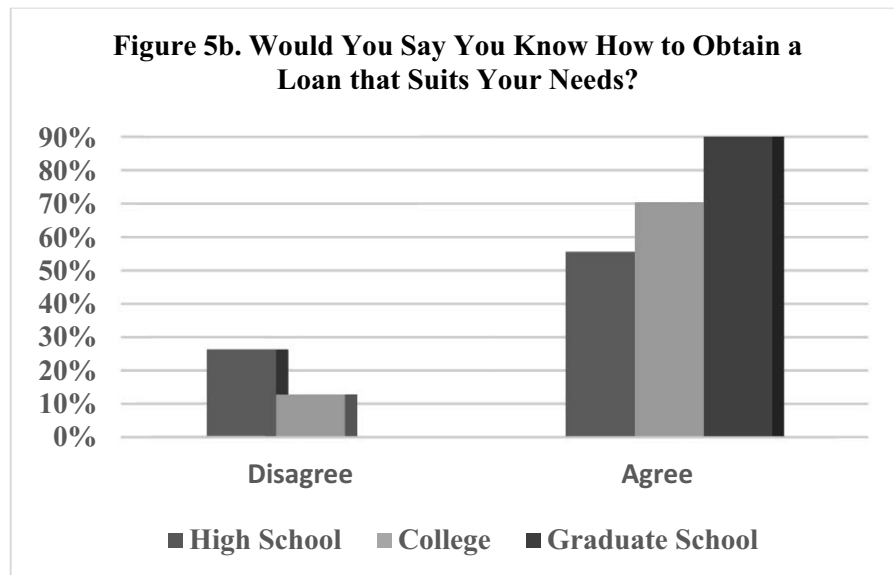
Table 7. Ordered Logit Regression Results, II.
Would You Say You Understand the Terms of Loans You Have Taken Out?

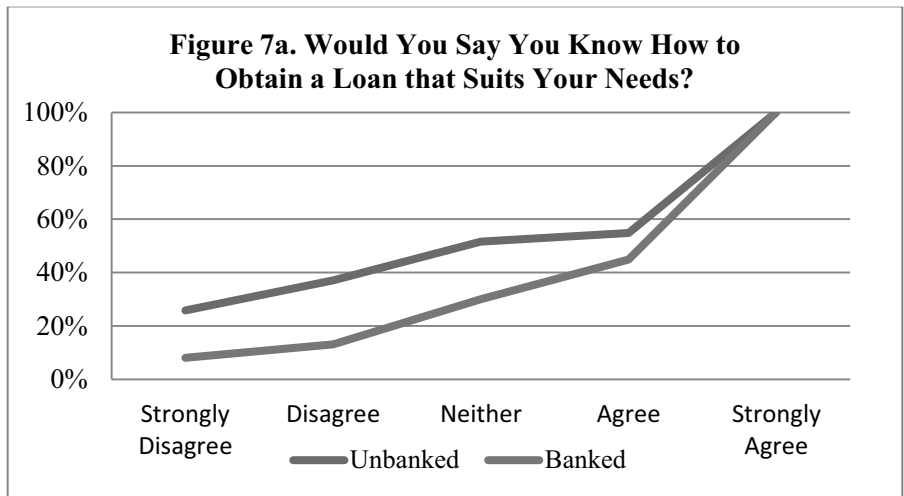
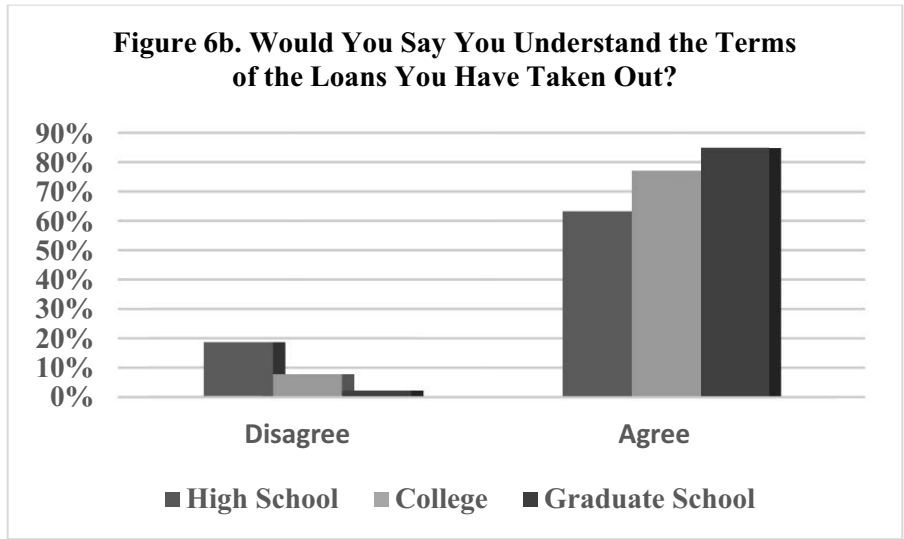
		<u>Regression Specification:</u>				
		(A)	(B)	(C)		
Intercepts:	Strongly Disagree	-2.614	-2.722	-2.753		
	Disagree	-2.118	-2.229	-2.257		
	Neutral	-1.082	-1.180	-1.204		
	Agree	-0.565	-0.690	-0.714		
	Unbanked	-0.565		-0.309		
	Standard Error	0.116		0.268		
	Significance, Wald	0.030		0.250		
	Maximum Education, High School		-0.624	-0.578		
	Standard Error		0.199	0.205		
	Significance, Wald		0.002	0.005		
	Nagelkerke Pseudo R-Square:	0.012	0.027	0.030		
	Chi-Square Test of Parallel Lines	11.14	2.93	11.37		
	Significance	0.011	0.402	0.078		
	Pearson Goodness of Fit Test	10.74	2.88	14.16		
	Significance	0.013	0.410	0.166		
		<u>Cumulative Predicted Probabilities, Regression (C)</u>				
		Strongly Disagree		Neutral	Strongly Agree	
		Disagree	Disagree	Neutral	Agree	Agree
Banked, Education > High School		6.0%	9.5%	23.1%	32.9%	100.0%
Banked, Education ≤ High School		10.2%	15.7%	34.8%	46.6%	100.0%
Unbanked, Education > High School		8.0%	12.5%	29.0%	40.0%	100.0%
Unbanked, Education ≤ High School		13.4%	20.3%	42.1%	54.3%	100.0%

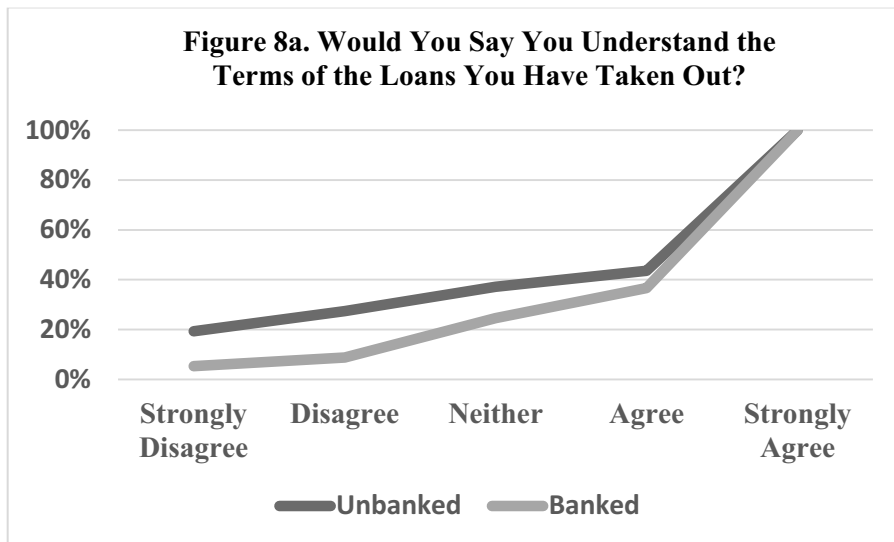
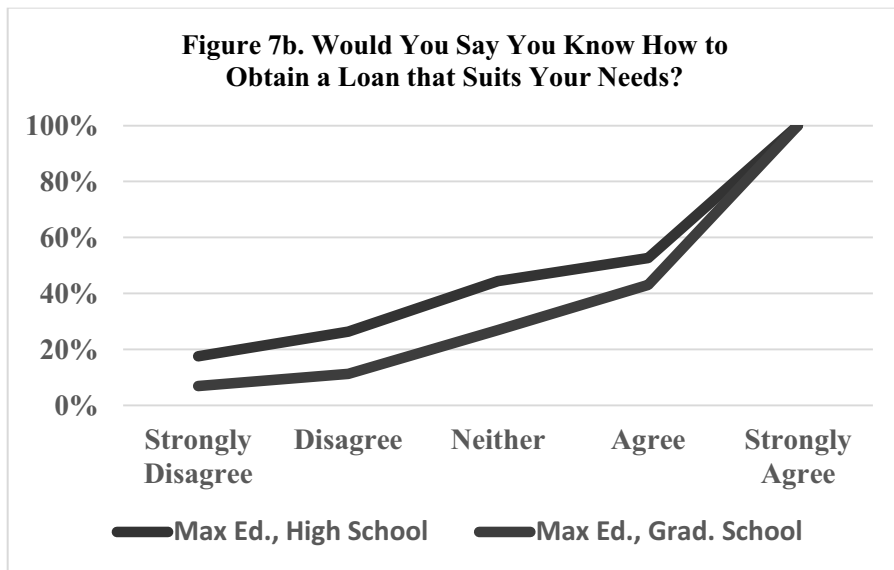


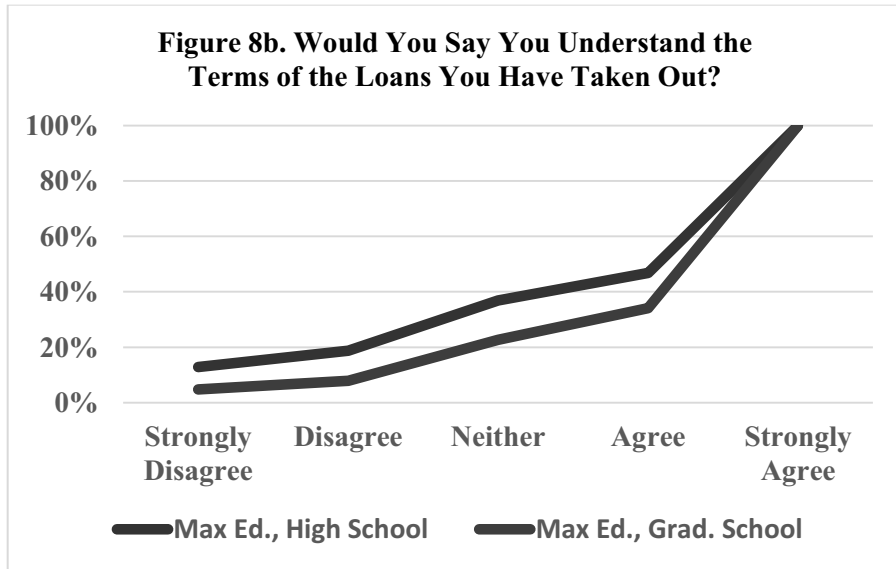












RATIONAL CONSUMER IGNORANCE:
WHEN AND WHY CONSUMERS SHOULD AGREE TO
FORM CONTRACTS WITHOUT EVEN READING THEM

*G. Marcus Cole**

ABSTRACT

Much of the literature on form contracts focuses upon either the unconscionable oppressiveness of their terms or justifications for denying them enforceability. Standard economic analysis of form contracting, however, suggests that the non-price terms of form contracts should, in theory, reflect the associated price terms. Within competitive markets, non-price form contract terms, like price terms, should favor consumers. But if this is true, then why is there so much anecdotal evidence of one-sided, anti-consumer non-price terms in form contracts?

Form contracts, like the other portions of the bundle with which they are associated, reflect the markets in which they are employed. The standard law and economics analysis accurately depicts form contracts used in markets characterized by high degrees of competition as “policed” by the marginal consumer for each non-price term. Less competitive markets, however, are more likely to have form contracts with more “one-sided” non-price and price terms. Still, the terms on such forms are likely to be policed by at least two other mechanisms, namely, *ex ante* public shaming, including social media shaming, and *ex post* lawsuits, whether or not these prove successful. In tandem, these policing mechanisms can be relied upon by consumers who rationally forego reading the terms of form contracts where the underlying market for the good or service is very competitive. The corollary of this is that, in markets involving product differentiation and more limited competition, non-price terms—like price terms—are likely to favor the party with monopoly or oligopoly market position. In such situations, consumers are well-advised to read the form contract in search of the terms that might matter to them personally in the long run.

* The William F. Baxter – Visa International Professor of Law, Stanford University. Many thanks are owed to J. Howard Beales III, Richard Craswell, Robert Hillman, Mark Kelman, Mark Lemley, Blake Morant, Maureen K. Olhausen, Nate Oman, Suzanne Reynolds, Jane Schacter, Jefferey Tasse, George Triantis, Robert Weisberg, Todd Zywicki, members of the National Association of Attorneys General, the participants in the Journal of Law, Economics & Policy Eleventh Annual Symposium on Consumer Credit and the American Economy, and participants in the Stanford Law School Faculty Workshop for helpful comments.

INTRODUCTION

Despite their ubiquitous use throughout our society and economy, form contracts are invariably viewed with contempt and derision. Courts have routinely enforced their terms, albeit while often “holding their noses.” Contracts scholars have written volumes about why form contracts, particularly ones written by lawyers for large corporations, ought not be enforced, especially against consumers. These types of forms have been pejoratively termed “contracts of adhesion.”¹ Recent scholarship employing approaches as disparate as “behavioral law and economics” and traditional jurisprudence have urged a departure from continued enforcement of form contract terms.

Such calls for a departure from traditional contract principles, as applied to form contracts, are shortsighted. A more nuanced understanding of the economics of form contracting reveals that non-price terms in form contracts are likely to “react” to market conditions in much the same manner as price terms. Furthermore, the responsiveness, or elasticity, of demand for non-price terms to market conditions should suggest to both consumers and regulators precisely when either should be wary of form contracts—and when they should not be. In other words, the question we should be asking is, “are there circumstances under which consumers are ‘protected’ by market conditions, such that it is perfectly rational for the inframarginal consumer to be ‘rationally ignorant’ of the non-price terms of the form contracts they are signing (but not reading)?”

This Article will attempt to answer to this question. The central claim here is that most non-price contract terms contained in standard form contracts are either benign or beneficial to consumers in many of the circumstances in which form contracts are employed. Part one provides a generalized economic analysis of form contracts. Such an analysis suggests that non-price terms in form contracts should reflect the market conditions under which they operate, in much the same way that price terms reflect such conditions. In markets characterized by significant product differentiation and inelasticity of demand, the terms of form contracts should reflect the superior position of the form drafter, in much the same way that sellers in such markets command higher prices. But if this is true, then the reverse should also be true, namely, that in markets characterized by heightened competition, terms in form contracts should reflect that heightened competition. Accordingly, just as prices in hotly competitive markets favor consumers, so should non-price terms.

There are reasons to trust that this should be so, and to conclude part one, those reasons are explained. First, non-price terms, like price terms, are “policed” in competitive markets by the marginal consumer for each term. Competitors failing to capture the marginal consumer for such terms under compet-

¹ See *Steven v. Fidelity & Casualty Co.*, 58 Cal. 2d 862, 882 n.10 (1962) (explaining the history of the concept of “contracts of adhesion”).

itive market conditions suffer the same fate as sellers who fail to compete on price.² Second, this type of policing is supplemented and enhanced by the transparency afforded by intermediaries and electronic media. Third, even where such efforts allow for unexpected, one-sided terms to “slip through,” the *ex ante* policing is supplemented by *ex post* reputation mechanisms, triggered by social media, lawsuits, and “old-fashioned” bad publicity.

Consumers, at some level, already intuit that the language of the form contracts which they sign—or for which they click “agree”—without reading, are much less dangerous than the alarmists would have them believe. Indeed, their ignorance of the actual terms of the contract is quite rational. In much the same way that political scientists have deemed the refusal of voters to devote inordinate time and energy to inform the casting of a single vote as “rational voter ignorance,” we can think of the failure of millions of inframarginal consumers to read the terms of their form contracts as “*rational consumer ignorance*.”³

Part two surveys the criticisms of form contracts. The concerns raised have persisted despite legislation and regulatory measures, such as disclosure requirements, designed to alleviate them. The criticisms are divided into two principle camps. First, the charge that “boilerplate” form contracts undermine democratic institutions and safeguards, leveled by philosophical legal pragmatists like Professor Margaret Jane Radin, are explained and addressed.⁴ Second, this part responds to the “behavioral law and economics” argument, made by Professors Russell Korobkin, Oren Bar-Gill, and others, that form contracts

² This very basic concept of microeconomics can be found in any introductory text on the subject. See, for example, RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* § 4.8 at 116 (Aspen 6th ed. 2003) (stating that, in a competitive market, sellers are forced to offer optimal form contract terms). See also Richard Craswell, *Passing on the Costs of Legal Rules: Efficiency and Distribution in Buyer-Seller Relationships*, 43 STAN. L. REV. 361, 369 (1991) (arguing that perfect competition is unnecessary for consumers to push toward efficient warranty terms); N. GREGORY MANKIW, *PRINCIPLES OF MICROECONOMICS*, 14 (7th ed. Cengage Learning 2014) (explaining marginal analysis); and STEVEN LANDSBURG, *PRICE THEORY AND APPLICATIONS*, 118 (9th ed. Cengage Learning 2013) (explaining marginal analysis and the equimarginal principle).

³ The phrase “rational consumer ignorance” was probably coined by Prof. Dan Klerman in the context of consumers’ unwillingness to read warranties, although Klerman’s conclusion was that rational consumer behavior in this regard justified a paternalistic approach to product warranties. See Daniel Klerman, *Personal Jurisdiction and Products Liability*, 85 S. CAL. L. REV. 1551, 1554 (2012). The concept of whether it is rational for consumers to forego reading form contracts has been discussed, but usually dismissed, by many authors before Klerman. See, e.g., Avery Katz, *Your Terms or Mine? The Duty To Read Fine Print in Form Contracts*, 21 RAND J. OF ECON. 518 (1990); and Abraham Wickelgren, *Standardization as a Solution to the Reading Costs of Form Contracts*, 167 J. OF INST. AND THEORETICAL ECON. 30 (2011).

⁴ See MARGARET JANE RADIN, *BOILERPLATE: THE FINE PRINT, VANISHING RIGHTS, AND THE RULE OF LAW*, 9 (Princeton Univ. Press 2014).

take advantage of consumers' cognitive infirmities, and therefore ought to be tightly regulated or disregarded altogether.⁵

Part three of this article attempts to categorize each of the kinds of contracts we commonly encounter into three different types, namely, (1) contracts consumers do not need to read, (2) contracts consumers probably should read, but for which they could also just "take their chances," and (3) contracts consumers definitely should read. This part also explains, for each of these types of contracts, why it falls into its particular category, rather than the others. In each case, the determination, of course, depends upon the existence and strength of term-policing mechanisms like the marginal consumer, media shaming, and legal action.

For regulators and law enforcement officials, this analysis suggests that efforts directed at protecting consumers in markets characterized by heightened competition are misplaced. To the extent that markets are characterized by firms with significant market share and little competition, such consumer protection efforts might prove more meaningful. This Article, however, is not advancing policy prescriptions in the realm of consumer protection. It merely points out an aspect of form contracts often overlooked by regulators, policy-makers, and scholars.

Part four concludes by suggesting an empirical research agenda designed to highlight the hitherto unnoticed "hidden treasures" tucked away in the non-price terms of form contracts that ultimately benefit inframarginal consumers.

To be clear, this Article only addresses the question as to whether it is rational for most consumers to forego reading most contracts. While this discussion may imply that the regulation of many form contracts through consumer protection legislation or regulatory activity may be superfluous or even misguided, such a claim is not within the scope of this Article. Nor does this Article attempt to explain when or how standard form contracts maximize welfare. Furthermore, this Article does not go so far as to address whether it is irrational for consumers to actually read the terms of their contracts. While these questions are of great importance, they must be left for another day. The scope of this particular Article is limited to an explanation of when and why it is perfectly rational, under certain circumstances, for consumers to agree to standard form contracts without reading or understanding the terms of such contracts.

⁵ See, e.g., Russell B. Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. CHI. L. REV., 1203, 1217-18 (2003); see also, Oren Bar-Gill, *The Behavioral Economics of Consumer Contracts*, 92 MINN. L. REV. 749 (2008).

I. SHOULDN'T CONSUMERS READ FORM CONTRACTS BEFORE SIGNING (OR CLICKING "I AGREE" TO) THEM?

A. *Considerations and Forms*⁶

Just after midnight on a clear February evening, a young lawyer and his wife—a corporate executive being recruited by a large, South Florida company—had just left a dinner party being thrown in her honor. As they were driving their rental car south along Interstate 95 back toward their Miami Airport hotel, they discussed the attractiveness of the offer to relocate. Suddenly, their rental car was struck from behind with tremendous force by another vehicle, sending the couple's car careening, first into the median barrier, and then across five lanes of traffic. The badly mangled car came to rest in a ditch along the shoulder of the road. The drunk driver who hit them fled the scene on foot, only to be captured by police dogs within the hour. Somehow, miraculously, the couple both survived the crash with relatively minor injuries. A Florida State Police officer at the scene remarked that he had never seen anyone survive such a violent crash. All but the front seat compartment of the car was completely crushed.

Although the lawyer and his wife were shaken by the collision, paramedics on the scene released them to return with the tow truck to the rental car agency, along with the unidentifiable wreckage that was the remains of their rental car. While the accident was as violent as it was sudden, nothing shocked the couple more than what happened next. As they walked through the door of the rental car agency, the lone clerk behind the counter greeted them, asked if they were all right, and then *handed them the keys to a replacement car!* When the lawyer asked why they were not confronted with a stack of paperwork, detailed questions, and a bill of some sort, the clerk explained that the credit card the young lawyer used to rent the car carried primary rental car insurance coverage. "Everything is already taken care of," replied the clerk. "Just sign here, and your replacement car is right outside the door."

The above story is a true one.⁷ It is also dumbfounding, especially for anyone who is familiar with the literature on form contracts, credit cards, and the need for "truth in lending" disclosure requirements.⁸ Here, an inconspicuous term in a form contract, signed by a lawyer/consumer who never took the time to read the "fine print"—let alone the required disclosures—provided the

⁶ This is, of course, a play on the title of the famous law review article, L. Lon Fuller, *Consideration and Form*, 41 COLUM. L. REV. 799 (1941). The pun is to point out the relationship between forms and the considerations weighed by individuals and firms that shape the terms contained in them.

⁷ These events occurred to the Author and his wife in Wintergarden, Florida on February 21, 1996.

⁸ The Truth In Lending Act of Title I of the Consumer Credit Protection Act of 1968, 15 U.S.C. § 1601 *et seq.*, requires disclosures of basic parameters of any extension of credit by a lender to a consumer. The regulations implementing the statute, known as "Regulation Z," are codified at 12 C.F.R. 226.

young lawyer and his wife with complete rental car collision insurance coverage, including the cost of months of physical therapy after the discovery of latent injuries from the crash.

But why? Why would a credit card company “foist” such unsought benefits upon a consumer who never bothered to look for them?

The answer, of course, is that the credit card company *had* to provide this benefit. This particular benefit was not provided as an act of beneficence, generosity or conscientiousness. It was not required by consumer protection statutes or lending regulations. It was not imposed by law enforcement as part of a consent decree. The reason the credit card company *had* to include primary insurance coverage in their form contact was because, if it did not, it would find it difficult to compete with other card providers for the one marginal consumer for whom this particular term mattered.

B. *The Marginal Consumers For Contract Terms*

One of the most fundamental precepts of microeconomics is that, within markets for goods and services, suppliers seek to supply as long as the marginal benefit of producing and selling one more unit exceeds the marginal cost of doing so.⁹ This means that as long as the supplier can find a buyer who prefers purchasing their good or service more than the price they must pay for it, they are going to “compete” for such buyers.¹⁰ There is, however, within the pool of potential buyers, one buyer who is so sensitive to price, that he or she is indifferent between the good or service offered and the price to be paid for it. This “marginal consumer” will walk away—or go buy the good or service from another supplier—unless the price is “competitive.”¹¹ “In a market with many producers and consumers, none of them actively sets the equilibrium price.”¹² The price is, in an indirect but very real sense, determined by the choices of the marginal consumer and the marginal producer. The supplier who wins this marginal consumer has maximized their profit from producing whatever it is they produce.¹³

The work of this marginal consumer can be illustrated on the simple “supply and demand” graph of Figure 1. The marginal consumer (point C_m in

⁹ This concept, known as “marginal analysis,” is a fundamental to economic analysis and price theory. See Landsburg, *supra* note 2, at 77 and 118; see also KEITH N. HYLTON, ANTITRUST LAW, 3 (Cambridge University Press 2003) (“Because the marginal consumer determines the price, all other consumers (infra-marginal) gain.”).

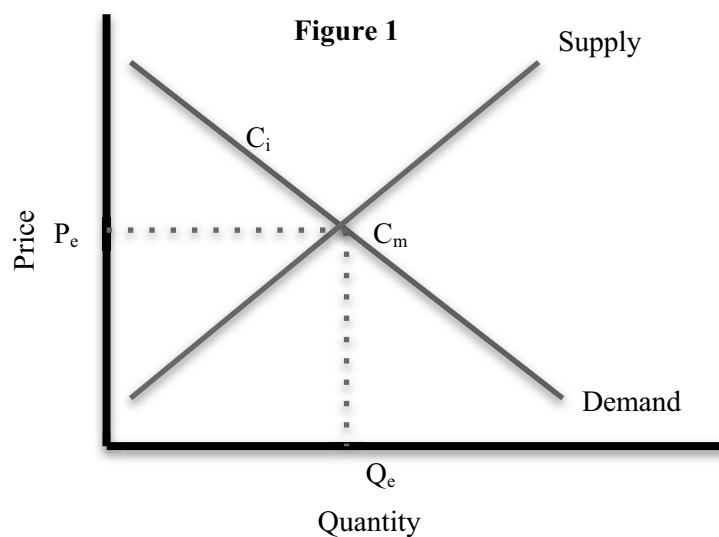
¹⁰ See PAUL KRUGMAN & ROBIN WELLS, MICROECONOMICS, 252 (3rd ed. Worth Publishers 2012) (explaining marginal analysis).

¹¹ *Id.* at 251.

¹² While this description is common to any text on price theory or microeconomics, the present discussion borrows heavily from the elegant version provided by Professor Keith Hylton in the introduction to his text on Antitrust Law. See Hylton, *supra* note 9, at 3.

¹³ *Id.*

figure 1) is one person who happens to be just indifferent between buying the good or service, and going without it, at the market price. Likewise, the marginal producer (at that same point C_m) is the one who is indifferent between supplying the good or service at the market price, and keeping its production. All of the “infra-marginal consumers” (all points, including point C_i to the left of point C_m along the demand curve) are each willing to pay more than the marginal consumer for the same good or service. Similarly, the “infra-marginal producers” are those willing to sell that good or service for a price lower than the one that the marginal producer would accept.



Together, then, the marginal consumer and marginal producer set the equilibrium price for the good.¹⁴

To see the power of the marginal actors in a market like that of Figure 1, suppose that the price is initially set at a level above the level that equalizes the quantity demanded and supplied. Sellers of the good would offer a larger quantity of the good than consumers would be willing to buy.¹⁵ This would leave some sellers to cut the price of their inventory to attract more buyers. This process would continue until sellers reached their marginal cost—the cost of producing the next unit, because to cut price further would mean to take a loss. Buyers who were unwilling to buy at the higher prices become more interested as the price drops. This continues until the equilibrium price is reached. Suppliers who seek to maximize their sales will continue dropping

¹⁴ *Id.*

¹⁵ *Id.* at 4.

the price until they capture the one last consumer ahead of their competitors. That consumer is the marginal consumer, at C_m .

Virtually everyone accepts that for most products in most markets, this is the way prices are driven. The marginal consumer—that one consumer for whom all of the suppliers compete—is unknown to the suppliers. All they know is that the marginal consumer is out there. If they knew everything there was to know about each of the consumers on the demand curve, suppliers would price their products at exactly the price that each was willing to pay, namely, the price where each one sits on the demand curve. This “price discrimination” can only take place, however, if each seller could know which consumers were willing to pay more, and how much more.¹⁶

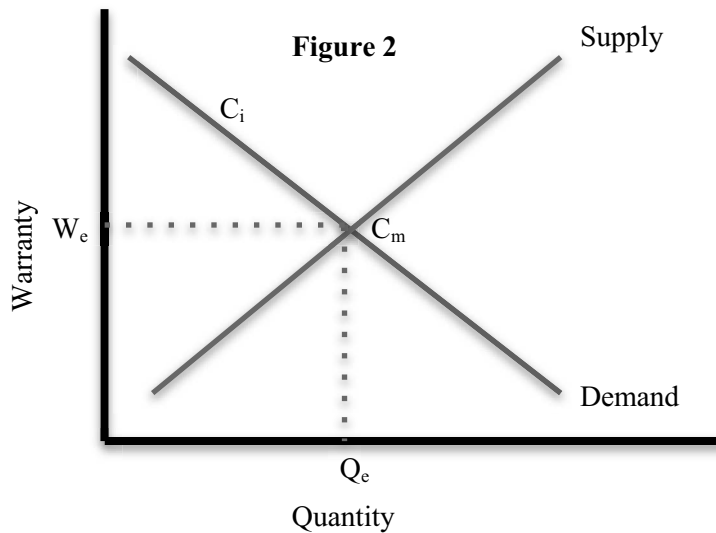
Because sellers cannot know this information in many markets, they must cut prices to keep capturing consumers along the demand curve. In perfectly competitive markets, sellers are, therefore, “price takers,” because they have no control over prices.¹⁷ Each seller must take the market price as given.

But everyone knows that prices are not the only terms about which consumers care. Some consumers care about warranty terms. Some other consumers care about the return policy. Yet other consumers care about whether the insurance on their rental car is “primary” or “secondary” coverage. And if prices are the same from one seller to the next, then sellers need to find another front upon which to do battle with their competitors. The non-price terms on form contracts provide just such a battle-front.

We can depict this competition in another graph, Figure 2. This second graph is virtually identical to the one depicted in Figure 1, except for one key difference. In Figure 2, the vertical axis represents the warranty term, rather than the familiar price term. Nevertheless, the very same dynamic is at work as in the first graph. If, in a competitive market, sellers were to set the warranty term such that they would never be liable for anything (a point higher than the equilibrium term), then some consumers would balk at purchasing the good or service. This would lead some suppliers to “lower” their warranty—in other words, make it more favorable to consumers—to gain more sales. This “lowering” of the warranty is just like the lowering of the price in Figure 1. Warranties would continue to get “better”—meaning, more attractive to potential buyers—until sellers could not afford to offer anything better. The point at which they settle, the “equilibrium warranty,” is that warranty term at which the marginal consumer of warranties for this product is just indifferent between buying and walking away. Since sellers wishing to maximize their returns will compete for this one last—marginal—consumer, it is this marginal consumer of the warranty term that sets the warranty for all, just as the marginal consumer of the price sets the price term for all.

¹⁶ See PAUL R. KRUGMAN AND MAURICE OBSTFELD, *INTERNATIONAL ECONOMICS - THEORY AND POLICY*, 142 (6th ed. 2003) (defining price discrimination as a pricing strategy where identical or largely similar goods or services are transacted at different prices by the same provider to different markets).

¹⁷ Hylton, *supra* note 9, at 10.



Just as there is a marginal consumer for prices in a competitive market for goods and services, so too, then, must there be a marginal consumer for *each* non-price term contained in form contracts.¹⁸

A warranty is an example of a non-price term in a contract. For warranties, the marginal consumer and the marginal supplier of warranty terms set the warranty term for the infra-marginal consumers and suppliers in the market. Suppliers in competitive markets, then, are “term takers” in the same way that they are “price takers.”¹⁹ Suppliers of a product with a warranty are therefore, “warranty takers.” Similarly, the marginal consumer and the marginal supplier of return policies set the return policy for the entire market. Suppliers of a product with a return policy are therefore, “return policy takers.” And so on. This is true because there is a marginal consumer for each term, and a marginal supplier for each term too. Together, these marginal consumers and marginal suppliers set the terms for the entire market along each dimension of the good or service sold.

¹⁸ Non-price competition has been well-studied in various contexts. See, for example, Duane G. Harris, *Interest Rates, Non-Price Terms, and the Allocation of Bank Credit*, 40 S. ECON. J. 428, 428 (1974) (explaining that credit rationing occurs when banks compete on non-price terms, even when holding interest rates fixed); Francesco Turino, *Non-Price Competition, Real Rigidities, and Inflation Dynamics*, 10 B.E. J. OF MICROECONOMICS 19 (2010) (showing the relationship between non-price competition between firms in the presence of real economic rigidities and inflation); Bastiaan Haan, *Price Fixing and Non-Price Competition*, J. OF ECON. REV. 2-26 (2008) (explaining the presence of non-price competition when firms engage in price-fixing arrangements); Philip G. Gayle, *Does Price Matter? Price and Non-Price Competition in the Airline Industry*, J. OF ECON. REV. 2-22 (2004) (demonstrating that airlines compete on non-price terms under price competitive conditions).

¹⁹ See Hylton, *supra* note 9, at 4.

Note: *these marginal consumers for these different terms are unlikely to be the same person.* That is because the marginal consumer, by definition, is the party for whom that particular term means the most. It is unlikely to be the case that one consumer will have two dimensions that will *both* serve as the crucial factor in their decision as to whether to consume or not.

As a market approaches perfect competition, producers will be driven by their desire to capture the custom of the marginal consumer *along each dimension*. This means that, for any given product market, there will be as many marginal consumers as there are dimensions to the product. There will be a marginal consumer for price, and there will be a marginal consumer for warranty. For low-interest, high-rewards-points credit cards, there will even be a marginal consumer for redemption periods, and for a low number of “black-out” dates. And yes, there will even be a marginal consumer for that all-important term, the primary car rental insurance coverage!

But what if this “marginal consumer” cannot read the terms, or is not sophisticated enough to understand the terms even if she can read them?

This question is like asking, “what if the marginal consumer for price cannot afford the product?” The answer, of course, is that if the “marginal consumer” for a product cannot afford the product, then they are not—and cannot be—the marginal consumer for that product. Demand for a good or service is defined as “a willingness and *ability* to pay” for it.²⁰ It follows, then, that a consumer who is without either the willingness or ability to pay for a product cannot be the marginal consumer for that product along the dimension of price.

Likewise, the consumer without the wherewithal to read, understand and evaluate the specific term that is important to him cannot be the marginal consumer for that term. The marginal consumer is, instead, someone who cares so much about that particular term, that she has educated herself, researched the product terms, and its closest substitutes along the margin of that all-important dimension—whatever it happens to be. The marginal consumer is an expert in the term about which she cares the most, in the same way that the marginal consumer along the dimension of price is an expert with regard to the price of the good or service and its substitutes.

The power of the marginal consumer for a non-price term is easiest to see in the various markets for the lowest interest rate credit cards. Since suppliers in these markets find it almost impossible to compete along the dimension of price (interest rate), they must find another dimension along which to do battle. In the process of finding other dimensions, they have discovered a clever way to at least segment the market further. So, some of these suppliers will offer the best interest rate, plus reward points. Yet others will offer that same, best interest rate, plus reward points, and a great website for redeeming those reward points. Yet another will offer the same, best interest rate, and a net-

²⁰ See Hylton, *supra* note 9, at 2; see also Landsburg, *supra* note 2, at 118 (emphasis added).

work of retailers with whom consumers can redeem reward points directly. There are, indeed, many, many websites, magazines and other intermediaries whose mission is to interpret reward points and evaluate rewards redemption systems, all in an effort to satisfy the marginal consumer's hunger for more information about that one dimension that is all-important to her.

Believe it or not, there is even a dimension, in the "prestige" credit card market, of "card feel." Along this dimension, card providers compete on the basis of card "heft," "plop sound," and other characteristics. Cards competing along this particular dimension can be made out of stainless steel (Marriott Rewards, Visa Black) or even a carbon-fiber matrix. Along other dimensions, some credit cards compete on customer's ability to "personalize" their cards—with a family vacation photo, for example.²¹

The key point is that within markets characterized by competition, suppliers are not in a position to price or term discriminate. They cannot "read" each potential customer's mind. Lacking this ability, they must then compete with each other along each of the dimensions of their product for each of the marginal consumers in their particular market. When it comes to such markets, we say that suppliers are "price takers," because the price is driven by the marginal consumer. Just as is true with price, such suppliers are also "term takers," because the contents of any particular term are driven by the marginal consumer for that term.

As a market, and its participants, drifts away from competitive pressure towards oligopoly or monopoly, the ability of the marginal consumer weakens or disappears altogether. This is because monopoly power, by definition, implies the absence of ready substitutes for a product along the dimensions about which consumers care.²² As product differentiation heightens, there is an inverse reaction in the power of the marginal consumer to police terms. When products differ significantly, it becomes impossible for an infra-marginal consumer to depend on the efforts of a marginal consumer along the dimension most important to her, because there is no way to know—without alternatives—what the "best" product might be along that particular dimension. In short, as a market approaches monopoly, where the demand for the underlying product is increasingly inelastic, the policing power of the marginal consumer decreases.²³

²¹ For an example of the array of credit card features, as well as in-depth analysis of each feature and benefit of every credit card, including detailed comparisons of each see the various credit card ratings websites and publications, like www.nerdwallet.com, <http://www.nerdwallet.com/the-best-credit-cards>; www.creditcards.com, www.creditcards.com/top-credit-cards.php; Consumer Reports Credit Card Buying Guide, <http://www.consumerreports.org/cro/credit-cards/buying-guide.htm>; and [cardratings.com](http://www.cardratings.com), <http://www.cardratings.com/>.

²² See Albert Choi & George Triantis, *The Effect of Bargaining Power on Contract Design*, 98 VA. L. REV. 1665, 1687-88 (2012) (explaining how the existence of monopoly bargaining power causes contract terms to one-sidedly favor the monopolist).

²³ *Id.* at 1689.

As a market becomes increasingly competitive, however, the reverse is true. The policing power of the marginal consumer is heightened. The intractable problem for suppliers within a competitive market is the difficulty of identifying the marginal consumer from infra-marginal ones. If Starbucks knew that a particular customer loved coffee so much that she would pay twice as much as the marginal consumer for coffee, Starbucks would change the price as she approached the cash register. This type of price discrimination is difficult in hotly competitive markets—but not impossible.²⁴ Airlines, for example, use “Saturday night stay” provisions to price-discriminate between business travelers and leisure passengers.²⁵ It is a well-established fact that business travelers are very unlikely to purchase travel that includes a “Saturday night stay.”²⁶ The fact that business travelers are, for a variety of reasons, less sensitive to price, allows an airline to charge more to travelers not staying over a Saturday night without experiencing a dramatic drop in ticket sales.²⁷

Just as price discrimination is a challenge for suppliers seeking to identify those willing to pay higher prices in markets with heightened competition, “*term discrimination*” opportunities are equally scarce. Suppliers may use various methods to accomplish term discrimination, but as with price discrimination efforts, they are usually less than perfect. Targeted advertising, for example, can “smoke out” potential customers to whom a particular term is meaningful.²⁸ Promotional “tie-ins” can do the same. A credit card company can run a promotion with a rental car company providing a special discount or rate for customers using one of their cards.²⁹ Even these efforts are but blunt instruments in the pursuit of the one last customer to consume that one last profitable unit of supply.

It is precisely because sellers within a highly competitive market must pursue the marginal consumer for *each* term of its contracts—price and non-price terms alike—and, because such sellers cannot distinguish the marginal consumer from the infra-marginal consumers of each term that the typical infra-marginal consumer is “protected” from one-sided or draconian terms and

²⁴ See Gayle, *supra* note 18, at 3.

²⁵ *Id.* at 2; see also J. D. Dana, *Advance-Purchase Discounts and Price Discrimination in Competitive Markets*, 106 J. OF POL. ECON. 395-422 (1998); see also J. Stavins, *Price Discrimination in the Airline Market: The Effect of Market Concentration*, 83 REV. OF ECON. & STAT. 200-02 (2001).

²⁶ See Dana, *supra* note 25, at 416.

²⁷ The “moral hazard” associated with business travel is just one of the oft-studied characteristics of the travel industry. See, for example, Leonard J. Basso, Matthew T. Clements, and Thomas W. Ross, *Moral Hazard and Customer Loyalty Programs*, 1 AM. ECON. J. 101-23 (2009) (demonstrating the effects of frequent flyer programs on third-party payer costs of business travel).

²⁸ See Rosa Branca Esteves & Paulo Guimaraes, *Price Discrimination and Targeted Advertising: A Welfare Analysis*, 1 IUP J. OF APPLIED ECON. 41-47 (2008) (demonstrating that consumer information revealed through responses to targeted advertising creates discrimination opportunities for suppliers).

²⁹ See S. J. Liebowitz, *Tie-In Sales and Price Discrimination*, 21 ECON. INQUIRY 387-99 (1983) (showing that tie-in sales can only lead to price discrimination if suppliers correctly predict consumer behavior).

prices. Furthermore, *because the “typical” or “average” consumer is “protected” by the diligence of the marginal consumer whenever encountering the terms within a form contract, it becomes perfectly rational for that typical or average consumer to agree to the terms of a form contract without even reading it.*

C. *The Blessings Of Forms*

It is not just the uneducated or illiterate, average consumer who forgoes the reading of form contracts. Judge Richard Posner once remarked that “[f]or my home equity loan, I got 100s of pages of documentation; I didn’t read, I just signed.”³⁰

Whether he agrees or not, it is quite rational for Judge Posner and other infra-marginal consumers to decide to go ahead and just sign their form contracts. But it is more than just rational; it is *good* for them, and *good* for society that they do just that. Form contracts can provide a host of benefits, not just to the drafter, but to consumers in general, and to society at large. These benefits can be called the “marshaling effects,” the “agency cost effects,” the “economy effects,” the “education effects,” the “transparency effects,” and the “piggy-back effects” of form contracts.

To the drafters of form contracts, their benefits are more obvious. First, and perhaps foremost, form contracts allow the drafter to marshal all of its legal talent and thought into one device. This device—the form—obviates the need for the costly negotiation of hundreds, if not millions, of transactions. Some of the transactions that might take place in a “formless” world would go the way the company desires; others would not. We can call this benefit of forms to the form drafter the “marshaling effect.”

The marshaling benefit of forms point to a second, related benefit of form contracts, namely, that they reduce the agency costs associated with transmitting the drafters’ desires to the forefront of the interaction with the other parties to their transactions. Agency costs are the costs associated with the gap between the desires of the principal and the actions of the principal’s agent.³¹ By using a form, the firm takes discretion away from its agent, and places its

³⁰ David Lat, *Do Lawyers Actually Read Boilerplate Contracts?*, ABOVE THE LAW (June 22, 2010, 2:42 PM), <http://abovethelaw.com/2010/06/do-lawyers-actaully-read-boilerplate-contracts-judge-richard-posner-doesnt-do-you/>.

³¹ The classic definition of “agency costs,” provided by Jensen and Meckling in their seminal article, is that it is the sum of (1) the monitoring expenditures of the principal; (2) the bonding costs of the agent; and (3) the residual loss. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305, 308 (1976), reprinted in THE SOCIOLOGY OF ORGANIZATIONS, 269 (Michael J. Handel, ed., Sage 2003). For a sampling of the large literature on agency costs, see Frank H. Easterbrook and Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 201 (1986); and James S. Ang, Rebel A. Cole and James Wuh Li, *Agency Costs and Ownership Structure*, 55 J. OF FIN. 81 (2000).

terms directly in front of the other party. This benefit can be called the “agency cost” effect of form contracts, because it reduces the agency costs arising when companies must use agents to transact with consumers or other businesses.

These two benefits generate a third benefit, namely, cost savings. A firm employing a form reduces, at the very least, its negotiation costs and its agency costs. But there is more. Forms can allow firms to think about and employ further cost-saving devices, and adopt these to apply universally to their transactions.

An example of cost-saving terms might be a “forum selection” clause. By using such a clause, a firm can know that disputes regarding its transactions will be resolved in a particular forum. This means that, rather than employ a team of thousands of lawyers and law firms in every jurisdiction, the firm can concentrate its legal talent in just one place.

A similar cost savings can be had with a “choice of law” term. Rather than operate under the uncertainties of the law of whatever jurisdiction might arise to decide its disputes, a firm can “hone in” on the expected value of litigation by incorporating a choice of law clause in its forms. “Arbitration clauses” drive the cost savings further, since the delays and additional expenses associated with litigation are avoided with faster, less costly arbitration processes.

When a firm saves on costs, particularly in a competitive market, the marginal consumer on the margin of price can drive down the price for all consumers, including infra-marginal ones, even further. Firms, as price takers, *must* charge the lower prices, passing on the savings to consumers. The cost savings afforded by form contracts can be thought of as yet another benefit, namely, the “economy effect.”

These cost savings are only the first of many benefits that form contracts afford consumers. The second may be just as important. By marshaling all of its legal talent—often very “high priced” legal talent—into one form, the firm drafting the form can distill into that one form all of its knowledge about the law and its experience within their particular market. As a repeat player in the market, the firm will have superior knowledge about the law, and the circumstances under which it will be engaged. If the firm’s lawyers and experiences tell it that a particular legal rule might be better—less costly, for example—than the prevailing rule, then they can craft the better rule as a term in their form. This form, then, allows the firm to contract around the “default rule” that governs in the absence of the form.

But how does a firm’s crafting of a specialized rule benefit consumers? The answer is that, if we craft default rules in favor of “one-shot” players, and against “repeat players” like the firms drafting the forms, then the form drafters must reveal their preference for the special rule by putting it into the form. Such a “penalty default” rule does more than shape transactions governed by the form; it reveals, by implication, that consumers might have been governed by a different, perhaps more favorable, rule in the absence of the term in the form.

This “education effect” of form contracts can be dismissed by Radin or others, since consumers rarely read or negotiate around such terms. But again, while that may be true of most, if not all infra-marginal consumers, it cannot be true of the marginal consumer for that term. The additional education afforded by the form to the marginal consumer throws off external benefits to infra-marginal consumers if and when the marginal consumer uses that additional information to act.

An example of the “education effect” or benefit can be seen in contracts for package delivery services. Within the Federal Express Terms and Conditions of Carriage is the following term:

FEDEX EXPRESS WILL NOT BE LIABLE FOR ANY DAMAGES IN EXCESS OF THE DECLARED VALUE OF A SHIPMENT, WHETHER OR NOT FEDEX KNEW OR SHOULD HAVE KNOWN THAT SUCH DAMAGES MIGHT BE INCURRED.³²

While this clause might be relatively meaningless to the unassuming consumer, it is very safe to say that every first year law student, as well as every lawyer, is intimately familiar with the default rule driving FedEx Express to include this term. The rule which FedEx Express seeks to avoid applying to its contracts is the well-known (to the legally trained) rule of *Hadley v. Baxendale*.³³ In *Hadley*, the court determined that a shipper could be held liable for incidental and consequential damages for the closure of a mill when it delayed the return of a repaired mill-shaft, it knew or had reason to know that such damages would be incurred by the mill as a result of the delay.³⁴

The rule of *Hadley* persists in all but one jurisdiction in the United States, and in most of the common law world. FedEx and its team of expert common carrier lawyers know this. Furthermore, FedEx and its team of lawyers do not want to be governed by the added uncertainties and costs to which the rule of *Hadley* exposes them. In order to avoid this exposure and these costs, FedEx has crafted its form to circumvent the default rule. While at first glance, this looks bad for consumers, it is actually beneficial for two reasons. First, the “one-shot” player/consumer need not seek out and employ the best common carrier lawyers in the nation to learn the rules associated with shipment (they are all working for FedEx in any event). Instead, the one-shot-player/consumer can know, from the FedEx form, by negative inference, what the rule would have been in the absence of the form. In short, the marginal consumer can know the rule of *Hadley v. Baxendale* without paying a penny of law school tuition, because FedEx’s lawyers have essentially told her what it is.

³² FedEx Express Terms and Conditions for U.S. Shipments, at 7 (2015), available at http://images.fedex.com/us/services/pdf/SG_TermsCond_US_2011.pdf.

³³ *Hadley v. Baxendale*, 9 Exch. 341 (1853).

³⁴ *Id.* at 342.

But there is more. Now that the marginal consumer knows what the default world is, she is free to “opt” for that world by paying for it. FedEx makes the world of *Hadley v. Baxendale* available to any consumer willing to pay the additional insurance to cover the additional costs.³⁵ This means that any consumer wanting the more expensive world of *Hadley* is able to get it, if, and only if, she is willing to internalize the costs associated with it.

This example of the education effect demonstrates that it has social welfare benefits as well. Because the more expensive rule of *Hadley* must be “paid for” by anyone who wants it, the rest of us who do not want or need it do not, as a result, have to subsidize the cost of the rule for those who want it. This means that FedEx has used its form, and the default rule around which it steers transactions, to segregate those who want the rule from those of us who do not. And it allows them to charge more to those who want the world of *Hadley*. The rest of us get lower cost shipments, ensured by the marginal consumer.

The key, of course, lies in the crafting of the default rule. The education effect can only take place if we purposefully craft default rules in favor of the “one-shot” player and against the “repeat” player. By doing so, we force the repeat player to divulge the information about the default rule through the drafting of a contract clause that circumvents it.³⁶

The benefits afforded by the education effect point to the greatest social welfare enhancing benefit of all, namely, the facilitation of the work of the marginal consumer. When firms employ forms, they make it easier for marginal consumers for each term to find and compare terms. With the terms articulated on a form, marginal consumers for each term can parse and compare, for the benefit of themselves and all infra-marginal consumers, the words employed within each term. This is clearly not a benefit to the form drafters; it clearly does benefit putative form accepters. We can call this benefit of form contracts the “transparency effect.”

As a result, everyone benefits from the use of forms in any markets where suppliers compete for business. The more competition, the more consumers, including infra-marginal consumers, benefit.

Consumers purchasing within a market characterized by heightened competition are able to “piggy-back” or “free ride” on the efforts of the marginal consumer for whatever term—price or non-price—that matters to them. All infra-marginal consumers enjoy this “piggy-back effect,” whether they realize they are benefiting or not. In fact, most do not realize that they are benefiting in this way, because such benefits are not intuitive. And because they are not intuitive, perhaps even counterintuitive, the benefits afforded by form contracts to the average, inframarginal consumer often escapes the appreciation of even the most sophisticated scholars, regulators, and lawmakers. Indeed, a

³⁵ See FedEx Express Terms and Conditions, *supra* note 32, at 7.

³⁶ For a complete discussion of the education effect of form contracts through default rules, see Randy E. Barnett, *The Sound of Silence: Default Rules and Contractual Consent*, 78 VA. L. REV. 821-911 (1992).

movement is afoot, and has long been underway, to address what they see as the form contract “menace.”

II. THE FORM CONTRACT “MENACE”

The foregoing benefits of form contracts are not widely appreciated. Indeed, some scholars and other commentators have declared form contracts to be “one of the greatest threats to the rule of law in a free society.”³⁷ But given the analysis presented above, along with the cheerful testimony of the very fortunate but surprised lawyer and his wife, the next question must be: “Why?”

Many of the reasons for the besmirched reputation of form contracts have been articulated by their critics. These criticisms can be grouped into two categories, namely, the “philosophical” critiques of legal pragmatists like Professor Margaret Jane Radin, and the “behavioralist” arguments of the fashionable “behavioral law and economics” movement. These arguments are perhaps best represented in the work of Professors Russell Korobkin and Oren Bar-Gill. Both the philosophical legal pragmatists, and the behavioralists, among many others, are mistrusting of form contracts and those that employ them. But why? Why are form contracts, and the companies that employ them, viewed with such derision and contempt? The arguments of each of these camps are addressed in turn.

A. *Philosophical Objections to Form Contracts*

If there is a campaign afoot against the use of form contracts, then the leader of that campaign is Professor Margaret Jane Radin. In her book, *Boilerplate: The Fine Print, Vanishing Rights, and the Rule of Law*, Radin describes what she views as the dual threats posed by form contracts, namely, the “normative degradation” and “democratic degradation” of individual rights.³⁸ Radin portrays these two forms of degradation as corporate threats to the rights of individuals, historically entrenched in the liberal theory underpinnings of the common law of contracts, and the democratic processes of contemporary legislation.³⁹ By “normative degradation,” Radin refers to the elevation of thoughtless, mindless acquiescence to forms to a status on par with that historically occupied by actual, “genuine” consent.⁴⁰

³⁷ See Radin, *supra* note 4, at 7.

³⁸ *Id.*

³⁹ By “liberal theory,” Radin is referring to classical liberal theory, in the tradition of John Stuart Mill, Frederic Bastiat, and William Blackstone. See Radin, *supra* note 4, at ____.

⁴⁰ Radin, *supra* note 4, at 19. It should be noted that cases on contract, going back hundreds of years, define the prima facie case as consisting of mutual “assent,” not “consent,” as Radin uses the term in her book. See, e.g., *Morales v. Sun Constructors, Inc.*, 541 F.3d 218 (3rd Cir. 2008) (finding *assent* essential to formation of a contract, even when the form to which a non-English speaker agreed was printed in English).

[M]ost of us are used to receiving paperwork (or its electronic equivalent) during transactions. We are given forms to sign when we rent an automobile or an apartment, and piles of forms to sign when we buy an automobile or a house. Most of us don't read them, and most of us wouldn't understand them if we did. We are given forms to sign when we get a job, when we join a gym, when we send our kids to camp. We click "I agree" to buy products or services on the Internet, after being shown lists of fine-print terms that we don't read. We receive forms even though we don't sign them or click "I agree," such as the fine-print terms of service interior to websites, or the fine print on everything from parking lot tickets to theater tickets to sports events tickets⁴¹

Radin's objection to form contracts goes deeper than the fact that we fail to read them and are subsequently bound by what we have not read. Her real concern is that the terms we have failed to read actually deprive of us of important rights, ones we would not relinquish if we thought about and understood what we were doing when we sign, or click our agreement to, these forms. For Radin:

[F]ine print has the effect of deleting recipients' legal rights. One common provision limits remedies for losses caused by a defective product or service to the replacement, repair, or reimbursement for the cost of the product itself, thus eliminating damages for injurious consequences of the product's failure. Another deletes ("disclaims") warranty coverage. Another says the firm will continue billing you forever for whatever you have purchased unless you notify it that you wish to terminate. Yet another waives recipients' user rights in information not protected by the law of intellectual property and otherwise free for public use; and still another waives information privacy rights.⁴²

Normative degradation, then, is nothing less than the ceding of rights without real, thoughtful agreement to the deprivation effected by the terms contained in these forms.⁴³

But form contracts, according to Radin, do much more than undermine rights of consumers without thoughtful agreement. By "democratic degradation," Radin believes there is something as serious, but more sinister afoot. She believes that form contracts act to undermine our democratic legal institutions—our elected legislatures and their laws—replacing them with the undemocratic, unilateral "law-making" of corporations and their teams of lawyers.⁴⁴ These legal foot soldiers are paid to craft forms depriving ordinary

Many treatises, cases, and other authorities explain the subtle difference between the two concepts. For one such explanation, see E. ALLAN FARNSWORTH, *CONTRACTS* (7th ed. 2003); see also, *RESTATEMENT* (2nd) *CONTRACTS* § 17 ("[T]he formation of a contract requires a bargain in which there is a manifestation of mutual assent to the exchange and a consideration."), and § 24 ("An Offer is the manifestation of willingness to enter into a bargain, so made as to justify another into understanding that his *assent* to that bargain is invited and will conclude it.") (emphasis added). One may speculate as to why Radin rhetorically chose to use the term "consent" when the law of contracts so clearly refers to assent and distinguishes it from consent.

⁴¹ Radin, *supra* note 4, at 7-8.

⁴² *Id.* at 11.

⁴³ *Id.*

⁴⁴ *Id.*

citizens of their all too alienable rights.⁴⁵ According to Radin, form contracts, and their drafters, actually undermine the democratic processes through which those rights were acquired.

Radin further suggests that forms accomplish both types of degradation under circumstances where consumers either know this is being done to them, but lack meaningful choice, or they are entirely unaware that this is being done to them.⁴⁶ She refers to this latter experience, the unwitting alienation of rights, as occurring under circumstances of “sheer ignorance.”⁴⁷

Radin presents an array of real-life examples of how the unread terms of form contracts proceeded to destroy the lives of unwary consumers who fell prey to the self-serving language hidden within the “boilerplate.”⁴⁸ One horrific example involves a safari tour company’s exculpatory clause that denied relief to grieving parents of an eleven-year-old boy mauled to death in his sleep by hyenas.⁴⁹

Among Radin’s examples is the case of *Carnival Cruise Lines v. Shute*,⁵⁰ a case familiar to every first-year law student. *Shute* is a favorite “whipping boy” among civil procedure instructors and those, including Radin, who think standard form contracts are the root of all evil.⁵¹ Indeed, *Shute* is one of the historically great examples of how bad facts make bad law, and even worse policy.

As for those bad facts, they are as follows. Mr. and Mrs. Shute, “through an Arlington, Washington, travel agent, purchased passage for a 7-day cruise on petitioner’s ship, the *Tropicale*,” a ship operated by Carnival Cruise Lines, Inc., headquartered in Miami, Florida.⁵² The agent for the Shutes sent the funds for the tickets to Carnival Cruise Lines, and upon receipt of the funds, Carnival sent the tickets to the Shutes.⁵³ The tickets contained a “contract page” which, among other things, contained the following clause:

It is agreed by and between the passenger and the Carrier that all disputes and matters whatsoever arising under, in connection with or incident to this Contract shall be litigated, if at all, in and

⁴⁵ *Id.* at 7.

⁴⁶ *Id.* at 8.

⁴⁷ *Id.*

⁴⁸ *Id.* at 8.

⁴⁹ The case to which Radin is referring is *Global Travel Mktg. v. Shea*, 908 So. 2d 392, 403 (Fla. 2005) (“An arbitration agreement constitutes a prospective choice of forum which trades the procedures and opportunity for review of the courtroom for the simplicity, informality, and expedition of arbitration.”). Radin, *supra* note 4, at 7, 249.

⁵⁰ *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585 (1991).

⁵¹ Radin discusses *Carnival Cruise Lines v. Shute* at 6, 137, 250-51, 281-83, 316 and 335.

⁵² *Shute*, 499 U.S. at 587.

⁵³ *Id.* at 587.

before a Court located in the State of Florida, U.S.A., to the exclusion of the Courts of any other state or country.⁵⁴

Mr. and Mrs. Shute boarded the Carnival Cruise Lines ship the *Tropicale* in Los Angeles, California, and sailed to Puerto Vallarta, Mexico. As the ship was sailing in international waters, Eulala Shute went on a guided tour of the ship's galley. During the tour, she slipped on a deck mat and was injured.⁵⁵ Upon their return, the Shutes filed suit against Carnival Cruise Lines in the United States District Court for the Western District of Washington. The Shutes claimed that Mrs. Shute's injuries had been the result of negligence by the cruise lines and its employees.⁵⁶

The District Court granted Carnival Cruise Lines' motion for summary judgment, holding that "the petitioner's contacts with Washington were constitutionally insufficient to support the exercise of personal jurisdiction," but not on the basis of the company's claim that the forum selection clause governed all disputes.⁵⁷ The United States Court of Appeals for the Ninth Circuit reversed the district court's judgment for the company, pointing out that the company solicited and accepted business in the state of Washington.⁵⁸ The Supreme Court, however, reversed the Ninth Circuit decision, and granted judgment in favor of Carnival Cruise Lines.⁵⁹ In writing for the Court, Justice Blackmun noted that "there is no indication that petitioner set Florida as the forum in which disputes were to be resolved as a means of discouraging cruise passengers from pursuing legitimate claims."⁶⁰ Furthermore, there was no indication that the company used fraud or deceit to secure the Shutes' assent.⁶¹ Absent such a finding, there was no basis to deprive the contract language force and effect, including its forum selection clause.

At the time that *Shute* was decided in 1991, 46 U.S.C. §183c provided that:

It shall be unlawful for the . . . owner of any vessel transporting passengers between ports of the United States . . . and a foreign port to insert in any . . . contract . . . any provision or limitation . . . (2) purporting [in the event of loss of life or bodily injury] to lessen, weaken, or avoid the right of any claimant to a trial by court of competent jurisdiction on the question of liability for such loss or injury, or the measure of damages therefor. All such provisions or limitations contained

⁵⁴ *Id.* at 587-88.

⁵⁵ *Id.* at 588.

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ *Id.* at 597.

⁶⁰ *Id.* at 595.

⁶¹ *Id.*

in any such . . . contract . . . are declared to be against public policy and shall be null and void and of no effect.⁶²

In 1992, the House of Representatives added “any” immediately before the phrase “court of competent jurisdiction.” Senator Breaux later remarked that the 1992 House addition:

was intended by the House to overturn the Supreme Court decision in *Shute* by making it unlawful for cruise ship operators to use provisions in passenger contracts to limit a claimant's right to a trial in any court of competent jurisdiction.⁶³

The amendment adding the word “any” originated in the House version of the Oceans Act of 1992,⁶⁴ sponsored by Gerry E. Studds of Massachusetts. Until the day of its adoption, this amendment had not been mentioned in debates or in a congressional report; it was apparently offered after both houses had completed their reports on the bill, and was first mentioned early on the morning of October 6, 1992, immediately before the House passed the statute and one day before the Senate did so (and three days before Congress recessed for three months).

“Nevertheless, Congressman Studds said on the House floor prior to enactment that the purpose of the amendment was to ‘overturn the result in *Carnival*’ and allow injured passengers to “choose the forum” and sue “in any court of competent jurisdiction.”⁶⁵

Then the law was changed again.

This time the amendment came from the Senate. As another piece of maritime legislation was making its way through Congress, Senators Ted Stevens and Ernest F. Hollings offered an amendment to the House bill, replacing everything after the enacting clause with new text. The new text included a provision deleting the word “any” from the Limitation Act paragraph in dispute in this case. The Senate passed this substitute on the day the amendment was offered, and the House passed the same version less than ten hours later. Three days later Congress recessed. When “any” was deleted from 46 U.S.C. §183c in 1993, Congressman Studds stated on the record:

⁶² *Compagno v. Commodore Cruise line, Ltd.*, 1994 WL 462997 (E.D. La. 1994). The legislative history of the *Shute* Amendments to the Oceans Act is recounted in *Reynolds-Naughton v. Norwegian Cruise Line Limited*, 386 F.3d 1, 3-4 (2004).

⁶³ 140 Cong. Rec. S1847-02, S1847 (daily ed. February 24, 1994).

⁶⁴ Pub. L. No. 102-587, § 3006, 106 Stat. 5039, 5068.

⁶⁵ *Reynolds-Naughton*, *supra* note 62, at 2, quoting 138 Cong. Rec. H11, 785 (daily ed. Oct. 5, 1992) (statement of Rep. Studds).

Section 309 of H.R. 2150 should not be construed to mean that a vessel owner may enforce a forum selection clause in a passenger ticket.⁶⁶

Congressman Studds' statement, however, was later expressly disclaimed by the Senate.⁶⁷

This discussion of how the "sausage was made" in the case of the law governing choice of forum clauses contained within cruise ship tickets is offered simply to show that corporations do not own a monopoly on fine print. Apparently, the inclination to slip language into a document with the knowledge that it is not likely to be read is one shared by legislators. And unfortunately, there is no "marginal congressman."

Clearly, some people get hurt by language in form contracts. But why? How is it that such things can happen? How is it possible for the terms of form contracts to seemingly defy the laws of economics, and wreak havoc in the lives of innocent consumers? And if they do cause pain and suffering so regularly, why do we continue to enter into them blindly? Proponents of behavioral law and economics believe that the answer lies in our refusal to acknowledge our psychological frailties.

B. *Behavioral Law and Economics Objections to Form Contracts*

Professor Radin is not alone in her assault on the form contract menace. Adherents to the application of insights afforded by behavioral psychology to the law, within the behavioral law and economics movement, are similarly taken aback by the widespread use and acceptance of form contracts. Within the movement the arguments of Professor Russell Korobkin and Oren Bar-Gill point to the infirmities of human understanding and behavior patterns that, in their minds, rob assent to such contracts of any legitimacy.

Korobkin points out that, unlike the traditional notion of contract, involving an actual bargain preceded by negotiations, many, if not most, contracts today are entered into without one or both parties fully understanding precisely to what it is they are agreeing.⁶⁸ Korobkin asserts that:

Efficiency requires not only that buyers be aware of the content of form contracts, but also that they fully incorporate that information into their purchase decisions. Because buyers are boundedly rational rather than fully rational decisionmakers, they will infrequently satisfy this requirement. The consequence is that market pressure will not force sellers to provide efficient terms.⁶⁹

⁶⁶ 139 Cong. Rec. H10928-01, H10941 (daily ed. November 22, 1993).

⁶⁷ *Compagno v. Commodore Cruise Line, Ltd.*, E.D. Louisiana, 1994 WL 462997 (1994).

⁶⁸ See Korobkin, *supra* note 5 at 1215.

⁶⁹ *Id.* at 1217-18.

Korobkin's analysis suffers from two shortcomings. First, he incorrectly presumes that the efficient functioning of markets requires knowledge—"awareness" as he puts it—by rational decision-making buyers and sellers. This is a demonstrably false but widely accepted and common misinterpretation of the efficient market hypothesis.⁷⁰ Many markets function efficiently without specific knowledge or awareness of the terms. Indeed, prices, including those of substitutes, convey all of the information necessary for such markets to operate efficiently.⁷¹ Buyers and sellers all around the world respond to and act upon commodity prices, for example, even when they speak different languages, operate under different laws and customs, eat different foods, and have different uses for the very same commodity in question.⁷² It is the price of wood that conveys whether there has been a forest fire resulting in scarcity. A consumer of wood need not know about the fire, only the price, to make an "informed" decision.⁷³

This first failing leads to his second, namely, his conclusion that the inefficiencies produced by boundedly rational beings "will force sellers to provide low-quality form terms, whether or not those terms are either socially efficient or optimal for buyers as a class."⁷⁴ This conclusion depends, in turn, on the unspoken assumption that the choices of the boundedly rational "average" or "typical" consumer drives the terms of contracts, because opportunistic sellers can capture large surpluses resulting from consumer error. This, too, is false.

Korobkin's conclusion that the frailties of consumer decision-making will open the door for opportunistic form-drafting misperceives the ways in which markets, particularly competitive markets, operate. As demonstrated earlier, a supplier who is unaware of the inner secrets of potential buyers will continue to supply an additional unit of output so long as the seller can find a buyer willing to pay at least its marginal cost of production.⁷⁵ This will continue through to a market-clearing equilibrium price that meets the seller's marginal

⁷⁰ Korobkin's unsupported assertion is a common misinterpretation of the efficient market hypothesis (EMH), which asserts that market efficiency depends upon the accurate communication of all available information through market prices. See COLIN READ, *THE EFFICIENT MARKET HYPOTHESISISTS: BACHELIER, FAMA, ROSS, SAMUELSON, TOBIN AND SHILLER*, 85 (Palgrave MacMillan, 2013) (explaining Paul Samuelson's view that the billions spent on market research only demonstrated the gap between the information available to traders and that reflected by market prices); see also Friedrich Hayek, *The Use of Knowledge in Society*, 4 AM. ECON. REV. 519, 530 (1945) (explaining the information conveyance mechanism of market prices).

⁷¹ Krugman & Wells, *supra* note 10, at 397 ("When prices work as economic signals, they convey all of the information needed to ensure that all beneficial transactions will occur."); see also Hayek, *supra* note 70, at 524.

⁷² Hayek, *supra* note 70, at 524.

⁷³ This example is borrowed directly from Hayek, *supra* note 70, at 528.

⁷⁴ Korobkin, *supra* note 5, at 1218.

⁷⁵ This is fundamental marginal analysis. See WILLIAM BAUMOL AND ALAN BLINDER, *MICROECONOMICS: PRINCIPLE AND POLICY*, 159-162 (13th ed. Cengage Learning 2015) (explaining that a supplier of a good will continue to supply as long as the next unit can be sold for the marginal cost of producing it, in order to capture the marginal consumer of it).

cost, one at which there is one marginal consumer who is indifferent between consumption of that last unit of output, or something else. It is the sale to this one, last marginal consumer that elevates one seller over its nearest competitor. For the custom of this one marginal consumer, producers will compete until the battle is won.⁷⁶

All consumers “behind” the marginal consumer, the infra-marginal consumers, are willing to pay more (or take less favorable terms) than the ultimately determined equilibrium. But not the marginal consumer. This one marginal consumer drives the terms for all less demanding consumers—unless producers can identify and discriminate against infra-marginal consumers who might be willing to pay more or take less favorable terms.⁷⁷ In other words, *in a market where competitive suppliers compete for the marginal consumer of a good or service, the terms desired by infra-marginal consumers do not matter; they are price and term takers, and the price and terms they take are the ones that attract the marginal consumer for each price and each term.*⁷⁸

Oren Bar-Gill’s behavioral economic analysis is similar, but proceeds in four steps, the first two of which he calls “descriptive.”⁷⁹ He poses these four steps in the form of four (actually five) questions:

Do consumers suffer from systematic misperception of the costs and benefits associated with certain products? And, do sophisticated sellers respond strategically to consumer misperception? In particular, do sellers design their products, contracts, and pricing schemes in response to consumer misperception? The third step is normative: is consumer misperception and, specifically, sellers’ strategic response to consumer misperception welfare-reducing? The fourth and final step is prescriptive: is legal intervention warranted and, if so, what type of legal intervention is desirable?⁸⁰

Affirmative answers to these questions would justify, in Bar-Gill’s mind, regulatory or statutory intervention on behalf of consumers. Of course, and quite predictably, Bar-Gill’s answers to the forgoing questions are “yes.” The problem is that he proceeds far too quickly to his step three.

As noted earlier, no seller in a competitive market can risk doing what Bar-Gill suggests, namely, designing products, including forms, to take advantage of consumers’ misperception, *unless the seller can distinguish—discriminate—between consumers*. If a seller can distinguish between consumers, and determine which ones will pay more or take less favorable terms, then yes, Bar-Gill is correct. Unfortunately for Bar-Gill (and fortunately for the rest of us), sellers usually cannot price discriminate or term discriminate in most competitive markets.

⁷⁶ *Id.* at 162.

⁷⁷ *Id.*

⁷⁸ *Id.*; see also Posner, *supra* note 2 at 116.

⁷⁹ Bar-Gill, *supra* note 5, at 749.

⁸⁰ *Id.*

The prototypical example of price discrimination occurs in the pricing of airline tickets. Airlines know that business travelers are unlikely to stay over a Saturday night, while leisure travelers often do. Because of this difference, airlines can charge—and collect—higher fares for travel terminating without a Saturday night stay.⁸¹

Bar-Gill is correct to note that many markets depart from the competitive ideal, and that under such circumstances, opportunistic form-drafting is both possible and likely. But to do so, sellers must be able to defeat the “police,” namely, the marginal consumer, and the *ex ante* and *ex post* intermediaries looking to expose abuses and inform others. Defeating the policing mechanism of the marginal consumer means to either differentiate the product so much as to make comparison between terms and substitutes meaningless, or to be able to identify where consumers fall on the demand curve—in other words, to price or term discriminate.

In order to defeat the marginal consumer, then, a seller must see her coming. In the airline industry, they sometimes can. But in many, many other markets, sellers have no such clairvoyance.

Under standard economic analysis, the terms of a contract, including the price and non-price terms, do not rely upon rational behavior or decision-making by infra-marginal consumers. The marginal consumer protects anyone less demanding, including Daffy Duck.

A simple example illustrates the point. A grocery shopper, rational or otherwise, need not check from supermarket to supermarket for the lowest price of milk, eggs, chicken or sugar. There is, for each one of these, a marginal consumer who will engage in precisely this task. The marginal consumer for the price of eggs will scour the advertisements, circulars, and the internet for the best price. So too will the marginal consumer for whole milk. Yet another marginal consumer will search for the best price for skim milk, and another for the lowest price for sugar. Because no supermarket knows for sure who each of these marginal consumers might be, they must lower their prices for each product to their marginal cost for each item. This is the only way they can compete for each marginal consumer. In the meantime, a complete lunatic who walks into a Safeway or a Von’s, despite being completely irrational, will pay no more for sugar or chicken than anyone else.

In short, *when it comes to markets characterized by competition between suppliers, it does not matter what the average person thinks or does*. They are infra-marginal consumers, and they do not drive the terms of the contracts to which all others are bound. Only one person matters for each term, price and non-price, and that person is the marginal consumer for that particular term.

⁸¹ For a recent and interesting description of price discrimination by airlines, see Steven L. Puller and Lisa M. Taylor, *Price Discrimination by Day-of-Week Purchase: Evidence From the U.S. Airline Industry*, 84 J. ECON. BEHAVIOR & ORG. 801 (2012).

C. *Why Does the Anecdotal Evidence of Form Contracts Seem To Defy Economic Explanation?*

If the marginal consumer for each term ultimately determines each term supplied on any suppliers' form contracts, then why do we often see outrageously one-sided terms in form contracts? Why is it that the standard law and economics explanation of form contracting fails to account for the horror stories that motivate Radin, Korobkin, Bar-Gill and others to call for limits on their enforceability? Part of the answer to this question may lie in the shortcomings of the standard law and economics analysis itself. That standard analysis may be overly simplistic. The devastatingly gruesome anecdotal evidence exposes an embarrassing hole between the accounts offered by the standard law and economics explanations, and the experiences of every one of us in our daily lives.

But that hole does not make the law and economics account wrong; it only demonstrates that it is incomplete. To complete it, we must recognize that non-price terms of contracts are no different than price terms in the ways in which they react to underlying market conditions. In other words, what happens to prices happens to other terms as well.

When considering market prices, economists of every bent have long recognized the effects of underlying market conditions upon such prices.⁸² As noted above, in competitive markets, sellers are "price takers," and the goods bought and sold have ready substitutes within a sea of fungible supply.⁸³ Furthermore, information flows cheaply or freely—through prices—and is ubiquitously available to all.⁸⁴ Sellers are price takers because consumers know where they can get the same thing at the same price. A seller choosing to price goods or services higher than the competitive market price dooms itself to failure.⁸⁵

Yet the standard account of the price mechanism is much richer than the rare commodities markets characterized by perfect competition. It is well established and understood that prices in markets characterized by monopoly, oligopoly, or monopolistic competition do not resemble those of competitive markets.⁸⁶ The more differentiated the underlying product, the fewer substitutes there will be for it. With fewer substitutes and suppliers, the more inelastic—or unresponsive—will be the demand for the underlying good. And the

⁸² Compare Krugman & Wells, *supra* note 10, at 252, with Baumol & Blinder, *supra* note 75, at 159.

⁸³ Baumol & Blinder, *supra* note 75, at 162.

⁸⁴ See Mankiw, *supra* note 2, at 66 ("Because buyers and sellers in perfectly competitive markets must accept the price the market determines, they are said to be 'price takers.'").

⁸⁵ Krugman & Wells, *supra* note 10, at 397 ("When prices work as economic signals, they convey all of the information needed to ensure that all beneficial transactions will occur.").

⁸⁶ See Choi & Triantis, *supra* note 22, at 1667-68. See also Mankiw, *supra* note 1, at 66 (if a seller charges more than the market price, "buyers will make their purchases elsewhere.").

more inelastic the demand, the more likely it will be that the supplier or suppliers of the good will extract higher, “one-sided” prices.⁸⁷

If this is true for price terms, then is it not also true for non-price terms? If non-price terms are terms like any other terms, including price terms, then they ought to be expected to react as any other term might react to underlying market conditions. In other words, as the level of competition in a market for a good or service decreases, we should not be surprised to see a proportionate increase in pricing power by suppliers.⁸⁸ And, in a similar vein, as the level of competition in a market for a good or service decreases, we should not be surprised if we see a qualitative and quantitative increase in the “one-sided” terms contained in the form contracts associated with the purchase of such a good or service. In short, the marginal consumer for a form contract term can effectively “police” that term where the market for the underlying good or service at issue is characterized by competition. If, however, there is significant product differentiation, such that there are multiple, and not one (or a few), points of comparison, then there is no one true marginal consumer policing each of the terms for the benefit of infra-marginal consumers.⁸⁹

The differences between form contracts within highly competitive markets and those within less competitive markets might explain why there are so many examples of “bad” or “nightmarish” form contract terms, with the concomitant nightmare anecdotes. In addition to the horror stories presented by Radin, social media is awash with each new example of a corporate form contract out of control.

A recent example can be found in the standard employment contract for Jimmie John’s restaurants.⁹⁰ The employment contract, which is agreed to by even minimum wage store clerks and janitorial staff, contains a noncompete clause so draconian that it essentially prohibits a terminated or departing employee from earning a living in any meaningful way.⁹¹ The clause went “viral”

⁸⁷ See Choi & Triantis, *supra* note 22, at 1667-68. See also Mankiw, *supra* note 2, at 94-96 (When demand is inelastic, sellers can charge a higher price because “the extra revenue from selling units at a higher price more than offsets the decline in revenue from selling fewer units.”).

⁸⁸ *Id.*

⁸⁹ Indeed, Bar-Gill himself comes very close to suggesting the nuanced standard economic analysis presented here. See Bar-Gill, *supra* note 5, at 762. Unfortunately, Bar-Gill believes that the realm of competitive markets is so small as to be negligible, and those in which term discrimination is possible quite large. See *Id.*

⁹⁰ See Dave Jamieson, *Jimmy John’s Makes Low Wage Workers Sign Oppressive Non Compete Agreements*, HUFFINGTON POST (Oct. 13, 2014), available at http://www.huffingtonpost.com/2014/10/13/jimmy-johns-non-compete_n_5978180.html; see also Clare O’Connor, *Does Jimmy John’s Non-Compete For Sandwich Makers Have Legal Legs?*, FORBES, (Oct. 15, 2014), available at <http://www.forbes.com/sites/clareoconnor/2014/10/15/does-jimmy-johns-non-compete-clause-for-sandwich-makers-have-legal-legs/>.

⁹¹ JIMMY JOHN’S EMPLOYEE CONFIDENTIALITY AND NON-COMPETITION AGREEMENT, available at <http://genius.com/Jimmy-johns-employee-confidentiality-and-non-competition-agreement-annotated>.

across the internet for precisely that reason.⁹² It also seems to have escaped the notice of commentators that under the law of most states, its medieval remedial scheme is unlikely to be enforceable.⁹³

The Jimmie John's non-compete clause is particularly interesting because it implicates two other "policing" mechanisms for form contract terms, namely, (1) intermediaries, and (2) reputation mechanisms. These mechanisms, by themselves and in tandem, facilitated by high-speed information transmission and advertising markets, deter form drafters from going too far, even in less competitive market conditions.

Private intermediaries, like Underwriters' Laboratories, the Insurance Institute for Highway Safety, Consumer Reports, C-NET, and others, serve as an important check on outrageously one-sided terms. For forms used in loan transactions, organizations like the Center for Responsible Lending operate as a non-profit, non-partisan watchdog over outrageous or unconscionable terms.⁹⁴ Each of these intermediaries have earned reputations for investigating products and services, and revealing their hidden or latent defects.⁹⁵

Even when information-disseminating intermediaries prove an ineffective *ex ante* check on overreaching by the drafters of form contracts, all is not lost. There are consequences to bad behavior, even if it ultimately proves perfectly legal and enforceable. These consequences include legal action, even if such action ultimately proves unsuccessful.

An example of such *ex ante* policing can be found in the lawsuits of the late 1990's against computer retailer Gateway, Inc. Gateway was an innovative marketer, selling its Gateway 2000 computers directly to consumers through a mail order business and farm-like retail stores.⁹⁶ The computers were shipped in boxes with the markings of Holstein cows, to promote its "down home," Midwestern image (the company was founded on a farm outside of Souix City, Iowa, and was headquartered in North Souix Falls, South

⁹² See, e.g., Evann Gastaldo, *Suit Reveals Jimmy John's Insane Noncompete Clause*, NEWSER (Oct. 15, 2014), available at <http://www.newser.com/story/197257/suit-reveals-jimmy-johns-insane-noncompete-clause.html>.

⁹³ Some commentators did, in fact, recognize the enforceability issues with the Jimmy John's non-competition clause. See, e.g., Ben Fink, *Is Jimmy John's Noncompete Enforceable Under Georgia Law?*, ATLANTA BAR JOURNAL, (Nov. 14, 2014), available at <http://www.atlantabar.org/blogpost/1046194/202493/Is-Jimmy-John-s-Non-Compete-Enforceable-Under-Georgia-Law>.

⁹⁴ The Center for Responsible Lending is a nonprofit, non-partisan organization that works to protect homeownership and family wealth by fighting predatory lending practice, with a focus on consumer lending: primarily mortgages, payday loans, credit cards, bank overdrafts and auto loans. See CENTER FOR RESPONSIBLE LENDING <http://www.responsiblelending.org/about-us/#sthash.uzhbNX4a.dpuf>.

⁹⁵ In fact, the Center for Responsible Lending was the recipient of the 2012 John D. and Catherine T. MacArthur Foundation Award for Creative and Effective Institutions, one of only 15 institutions in six countries to receive the award that year. See MACARTHUR FOUNDATION <http://www.macfound.org/press/from-field/center-responsible-lending-2012-macarthur-award-creative-effective-institutions/>.

⁹⁶ See Douglas A. McIntyre, *The 10 Biggest Tech Failures of the Last Decade: Gateway*, TIME, (May 14, 2009), available at http://content.time.com/time/specials/packages/article/0,28804,1898610_1898625_1898628,00.html.

Dakota).⁹⁷ Gateway was the first major manufacturer to offer a suite of family-friendly software, the first optical drive as standard equipment, and the first sub-\$1,000 personal computer.⁹⁸ Gateway also introduced the industry's first sub-prime financing program, called Gateway for All.⁹⁹

All of these innovations painted Gateway as a consumer-friendly company. Then the lawsuits came. Rich and Enza Hill bought a Gateway 2000 computer and kept it for more than 30 days before complaining about the components and performance of the machine.¹⁰⁰ The Hills filed suit in federal court on behalf of themselves and a class of all other purchasers, alleging wire and mail fraud, as well as violations of the federal Racketeer Influenced and Corrupt Organizations Act ("RICO"), claims which would have entitled them to treble damages.¹⁰¹

Gateway moved to dismiss on the grounds that its form, which was enclosed inside its Holstein-painted box, contained a clause requiring the arbitration of disputes.¹⁰² The Hills acknowledged noticing the form, but not to having read it.¹⁰³ The Seventh Circuit reversed a district court's denial of Gateway's motion to dismiss.¹⁰⁴ Writing for the court, Judge Frank Easterbrook made it clear that the Hill's acquiescence to the form required enforcement of all of its terms, including the arbitration clause.¹⁰⁵

Gateway's victory was short-lived. Other lawsuits followed, complaining of the product as well as of the terms in its form contract. In a district court in Kansas, Gateway soon learned a hard lesson in federal jurisdiction. William Klocek brought suit against Gateway, on behalf of himself and a class of purchasers, for flawed personal computers.¹⁰⁶ Judge Vratil ruled that the difference between the terms on the form and those articulated by the buyers at the time of purchase gave rise to a "battle-of-the-forms" under the Kansas version of Uniform Commercial Code section 2-207.¹⁰⁷ Under a "battle-of-the-forms" analysis, inconsistent terms knock each other out. In the case of Klocek's purchase of Gateway's computer and form, the arbitration clause was "to be construed as proposals for addition to the contract," to which the consumer must show further assent.¹⁰⁸ Since that assent was never manifested, the arbitration clause was not part of the contract, and Klocek's lawsuit could proceed with

⁹⁷ See Gateway, Inc. History, FUNDING UNIVERSE, available at <http://www.fundinguniverse.com/company-histories/gateway-inc-history/>.

⁹⁸ *Id.*

⁹⁹ *Id.*

¹⁰⁰ Hill v. Gateway 2000, 105 F.3d 1147 (7th Cir. 1997).

¹⁰¹ *Id.* at 1148.

¹⁰² *Id.*

¹⁰³ *Id.* at 1148.

¹⁰⁴ *Id.* at 1147.

¹⁰⁵ *Id.* at 1148.

¹⁰⁶ Klocek v. Gateway, 104 F.Supp. 2d. 1332 (D.. Kan. 2000).

¹⁰⁷ *Id.* at 1339.

¹⁰⁸ *Id.*

the denial of Gateway's motion to dismiss.¹⁰⁹ The Seventh Circuit's writ, as well as Judge Easterbrook's wisdom, extended only as far as the Mississippi River.

Gateway lost more than just one lawsuit. It lost considerable reputation among consumers in the marketplace. It soon was widely regarded as the poster child for poor customer service, in no small part because of the attention garnered by the lawsuits.¹¹⁰ By April 1, 2004, Gateway's reputation among consumers was so tarnished, that it decided to close its 188 remaining retail stores.¹¹¹ To be sure, the company retained considerable value, and was ultimately acquired by Acer Computer in October 2007 for \$710 million.¹¹² But it had been worth billions just a few years earlier. The real question is, "what would the company have been worth if it had not insisted upon, and tried to enforce, those arbitration clauses, rather than just replace or refund its faulty products?"

The Gateway saga illustrates the third policing mechanism supplementing the efforts of the marginal consumer and information intermediaries, namely, the *ex post* policing of legal action. Of course, legal action is neutered, to a large extent, by the enforceability of the terms of form contracts. But to the extent that lawsuits expose outrageous or unconscionable terms, they raise the uncertainty associated with legal enforceability, and the ultimate "cost" of the forms in question.

In addition to the "marginal litigant," forms are also policed *ex post* by legal intermediaries, namely, organizations whose mission it is to promote the interests of consumers and others against overreaching contract language encased in forms. The Electronic Frontier Foundation, for example, actively engages in litigation and amicus-brief-writing to attack, among other things, the enforceability of outrageous or unconscionable "terms of service" or "terms of use" asserted in cyberspace.¹¹³ Other public interest law firms, legal clinics, and think tanks offer their resources to those seeking to establish an *ex post* backstop against oppressive form contract terms. This is not to suggest that the *ex post* policing through the threat or filing of lawsuits is always, or

¹⁰⁹ *Id.* at 1344.

¹¹⁰ See RONALD ALSOP, THE 18 IMMUTABLE LAWS OF CORPORATE REPUTATION: KEEPING, PROTECTING AND REPAIRING YOUR MOST VALUABLE ASSET, 122 (2004) (Gateway's "market share and reputation quickly eroded, and the company finally conceded that a lack of accountability and discipline had hurt its performance.").

¹¹¹ See Gateway, Inc. History, FUNDING UNIVERSE, available at <http://www.fundinguniverse.com/company-histories/gateway-inc-history/>.

¹¹² See McIntyre, *supra* note 96, at 14 ("The \$710 million price tag is quite a comedown from the mid-1990s, when Gateway and Dell (DELL) were spoken of in the same breath and commanded mega-billion dollars in market capitalization.").

¹¹³ See, e.g., Electronic Frontier Foundation's "outing" of the Pinterest "Terms of Service," *Pinterest's Pernicious Terms of Service* available at <https://www.eff.org/deeplinks/2012/04/pinterests-pernicious-terms-service>.

even often, successful; it merely imposes a cost that cannot be discounted by the drafters of forms.

III. WHICH FORM CONTRACTS SHOULD WE READ?

The next question we need to ask ourselves, then, is “which form contracts do we need to read?” The analysis above would seem to suggest the answer. *The more reliable the policing mechanisms for contract terms, the more rational is the choice to forego reading those terms.* This means that, the more competitive the market, or the more scrutiny afforded by intermediaries or media outlets, the more likely it is that the terms of the contract either favor consumers, or are neutral between the interests of consumers and those of the drafter of the form. In this regard, when competitive forces, intermediaries, and media scrutiny reinforce each other, the more likely it is that consumers actually benefit from the terms of form contracts. On the other hand, where such policing mechanisms are limited or unavailing, consumers are well-advised to carefully read the terms of their form contracts themselves.

This discussion suggests that form contracts fall on a sliding scale from “no need to read” to “better read carefully” and everything in between. Nevertheless, it may be helpful to provide concrete examples of precisely which kinds of common, everyday form contracts fall into each of three categories. Form contracts can be regarded as one of three types, namely, (1) form contracts that we do not need to read, (2) form contracts that we ought to read, but for which we can probably “take our chances,” and (3) form contracts that we definitely ought to read. The use of these categories for purpose of illustration should not be taken to mean that the categories are “hard” ones. The scale is a “sliding” one, and there will be contracts on the borderlines between categories. There will also be outliers. Nevertheless, the forgoing analysis should help in explaining when and why certain forms may cross these borders and defy these broad categories.

A. *Form Contracts We Do Not Need To Read*

1. Credit Card Agreements

For the most part, credit card agreements need not be read by consumers. If we understand the markets in which credit card issuers and their products operate, we quickly realize that credit cards, like most consumer credit, exists in highly fragmented markets. Money is, of course, the ultimate commodity. In economic terms, a commodity is a product for which any unit is completely

fungible and undifferentiated from any other unit.¹¹⁴ When one deposits a dollar in a bank account, and then returns later to withdraw it, she does not argue that she did not receive precisely the same dollar with the same serial numbers as was deposited earlier. Each unit of money is as interchangeable as grains of wheat, whatever the source. As a result, money is “bought” and “sold” in markets in much the same way that wheat, soybeans, or other commodities are bought and sold. When money is borrowed, it is borrowed at a price—the interest rate. But the differences in price with which money can be “bought” depend, not upon the characteristics of the money itself, but rather, the characteristics associated with the borrowers attempting to “buy.”

Credit card markets are a subset of the larger market for the commodity we call money. While it is true that credit cards can differ wildly with regard to their costs and benefits, it is not true that such differentiation occurs within the market segments. Credit card markets are segmented by the credit ratings of the consumers for which they vie. Within each segment, competition is fierce; this competition does not take place across or between market segments. As a result, it is a mistake to compare terms offered within one segment with those offered within another. Terms across segments can be radically different, making it appear as though there are “good” lenders and “evil” ones. For this reason, credit card issuers have become the favorite “whipping boy” of populist scholar-turned-politician Elizabeth Warren, and many, many others.¹¹⁵

Credit card terms, however, are prototypical of the kinds of terms within markets that are fiercely policed by marginal consumers. For and within each segment of the market, a marginal consumer ensures faithful compliance with the demands of consumers near or at the indifference point. For example, consumers with excellent credit, who pay their full balances each month, and who prefer travel rewards and benefits for the dollars they funnel through their card issuers, can rely upon an army of consumers near or at the margin to intensely

¹¹⁴ Even Karl Marx recognized this point. *See, e.g.*, KARL MARX, *SELECTED WRITINGS*, 252 (Lawrence Simon, ed. 1994) (“[A]ll other commodities express their values in a particular commodity because it is money.”). *See also*, FRIEDRICH A. HAYEK, *GOOD MONEY: PART 2*, 242 (“the general reason why people use money as a medium of exchange is that such a commodity possesses a greater degree of acceptability or that it is likely to be more accepted than other commodities.”); BENJAMIN GRAHAM, *CURRENCY MARKET: MONEY AS PURE COMMODITY* (Editorial Benai Noaj 2009) (exploring money as a commodity in itself, and its relationship to gold and silver); *but see* TARIQ ALRIFAI, *ISLAMIC FINANCE AND THE NEW FINANCIAL SYSTEM: AN ETHICAL APPROACH TO PREVENTING FUTURE CRISES*, Chapter 7 Key Principles of Islamic Finance – Definition of Money Under Sharia Law (2015) (Under Sharia Law, “money is not a commodity. It cannot be discounted or sold in advance. It cannot earn a return on its own by being lent out.”).

¹¹⁵ *See e.g.*, *Credit Card Practices that Undermine Consumer Safety: Hearing Before the Subcomm. on Financial Institutions and Consumer Credits*, Testimony of Elizabeth Warren March 13 2008, available at <http://archives.financialservices.house.gov/hearing110/warren031308.pdf>; Elizabeth Warren, Commentary, *The Secret History of the Credit Card*, *Frontline* and *New York Times* (2005) available at <http://www.pbs.org/wgbh/pages/frontline/shows/credit/view/>; Elizabeth Warren, *Unsafe at Any Rate*, *DEMOCRACY: A JOURNAL OF IDEAS* 8 (2007).

scrutinize each line and each word of their card agreement provisions. From time to time, borrowers who never bothered to read the forms containing the terms of their agreements will find wonderful things like primary rental car insurance coverage “foisted” upon them at times of unexpected need.

As the credit history of potential borrowers declines, so too do the features of the card products offered to them. Still, within each of these segments, the competition for these higher-margin opportunities is elevated, and a marginal consumer for each category expends the time and energy to find the best value. At the bottom of the credit market, where borrowers have sketchy credit histories and fewer issuers preferring the risks, even “secured” credit cards have marginal consumers who, if they have a choice, will choose the best value among their alternatives.

The differences between the products at different points in the spectrum make it appear as though there are dramatic, uncompetitive differences between card products. Looks, however, are deceiving. As has been well-documented by Todd Zywicki and others, the 16 numbers and hologram on a particular credit card do not, by themselves, place it within the same product markets as other implements having these same characteristics.¹¹⁶ Credit cards are different products, not because of their physical features, but because of the different kinds of customers to whom they are available. But because these products are, in the end, money (the ultimate commodity) at a price, they are bought and sold in markets that are very, very close to perfect competition. Under such conditions, reading the terms of the contract is a waste of time for all but the marginal consumer for each term.

2. Home Mortgage Documents

Another type of form contract to which consumers need not devote substantial time reading is the typical home mortgage document. This classification is admittedly quite counterintuitive; a mortgage is likely to be the largest obligation any of us is likely to undertake in our lives. Service on the debt effected by a mortgage is also likely to be the largest line item in anyone’s budget. Nevertheless, these documents are also the least likely to require close reading or scrutiny. Why? Because, in the hotly competitive markets within which home mortgages are offered, the vigilance of marginal consumer, with help from each of the competitors, protects us all.

Although not quite as segmented as the many markets for credit cards, the markets for home mortgages are characterized by significant levels of segmentation. Within each of these segments, competition between “sellers”—

¹¹⁶ See TODD ZYWICKI, THOMAS A. DURKIN, GREGORY ELLIEHAUSEN & MICHAEL E. STATEN, *CONSUMER CREDIT AND THE AMERICAN ECONOMY* 290-93 (Oxford University Press 2014) (explaining the variety of products that fall under the rubric of “credit card,” fragmented by consumer credit history and risk).

mortgage lenders—is quite fierce.¹¹⁷ Only a few borrowers have the credentials to qualify for the best mortgage rates, and mortgage lenders compete ruthlessly for these few, low-risk borrowers. As credit scores fall, interest rates rise, and at each platform along the way, there are lenders specializing in the types of borrowers found at each level. At the lower end of the “lendable” market, sub-prime borrowers have few choices for lenders willing to lend at such high a risk, and the limited competition creates opportunities for lenders to craft terms that better-situated borrowers would never agree to—if they actually read the terms. Fortunately, each segment within these mortgage markets has marginal consumers who will ferret out unsavory terms, and a lender attempting to sneak in a one-sided term will lose them to competitors.

3. Airline Tickets

Given the earlier discussion of the airline industry’s well-known ability to engage in price and term discrimination, it may seem quite odd at this point to suggest that airline tickets need not be read. Nevertheless, there are limits to the foresight afforded suppliers of air travel. Few markets are as hotly competitive as markets for transportation. Taxi drivers have learned this the hard way; even hard-earned government-provided and protected medallion monopolies have fallen in recent years to technological advancements in the form of mobile telephone ride-sharing applications like Uber and Lyft.¹¹⁸ Ever since the deregulation movement of the 1970’s, airline travel has joined other modes of transportation as among the most competitive of markets.

Because airline passengers often encounter dramatically disparate prices for travel, even within the same cabin on the same flight, there is a widely held but incorrect belief that airlines are anything but price takers. This perception, however, could not be further from the truth. Airlines have so little market power that their entire existence depends upon the relationship between the cost structure of their labor agreements, especially the all-important pilots’ union contract, the efficiencies afforded by their “hub and spoke” network, and

¹¹⁷ See Richard J. Rosen, *Competition in mortgage markets: The effect of lender type on loan characteristics*, ECON. PERSP. 1 Federal Reserve Bank of Chicago 1-21 (1st Qtr. 2011) (demonstrating the effects of lender characteristics on competition to place loans). See also COMPETITION IN REAL ESTATE AND MORTGAGE LENDING: HEARINGS BEFORE THE SUBCOMMITTEE ON ANTITRUST AND MONOPOLY OF THE COMMITTEE ON THE JUDICIARY, United States Senate, 2013 (detailing the various levels and extent to which mortgage lenders compete in real estate financing throughout the United States).

¹¹⁸ See, e.g., Toby Sterling, *Dutch Regulators Raid Uber Offices Over Court Ruling Compliance*, Reuters, (March 26, 2015), available at <http://www.reuters.com/article/2015/03/26/us-uber-netherlands-raids-idUSKBN0MM1LW20150326> (describing how governments have acted to protect taxi drivers from competition made possible by Uber and Lyft).

their ability to effectively minimize and hedge their fuel expenses in futures and commodities markets.¹¹⁹

The reason for the disparities in the prices of airline tickets, and in their concomitant terms, is due to the fact that airlines sell multiple products, all of which are disguised as tickets on the same flight. When a business traveler sits next to the vacationer, it is true that they are on the same flight, but they are not consuming the same product. The airline's ability to price discriminate between types of passengers allows them to sell different products to each. The product for one passenger is business travel; the product for the other is leisure travel. The ability to price and term discriminate between types of passengers *across* categories does not, however, allow airlines to price and term discriminate *within* categories of passengers.

Just as there is a marginal consumer for the price of eggs or butter, there is, likewise, a marginal consumer for vacation travel with a Saturday night stay, as well as for business travel terms (like the ability to sidestep the long check-in line at the airport). Because the categories of passengers are so broad, there is still ample competition between carriers for customers within each category or market segment. The heightened competition is only "softened" a bit by the rough price discrimination. Within categories of airline tickets, then, the marginal consumer for each term, including the price and non-price terms, make reading those detailed "fare rule and restrictions" an unprofitable use of time for consumers.

4. New Automobile Warranties (But Not Extended Warranties)

The warranties for new cars are among the most scrutinized form contracts known to modern science. In addition to the marginal consumer, dozens of intermediaries have carved out a sizeable market niche by providing detailed analysis of the terms associated with the purchase of a new automobile. In fact, the otherwise sophisticated marginal consumer gains the benefit of even more sophistication and knowledge from publications and websites whose market contribution is the "increase and diffusion of knowledge" regarding each and every vehicle manufactured. Auto purchase intermediaries include periodicals (Car and Driver, Autoweek, Road & Track, Motor Trend, et al.), ratings agencies (Consumer Reports, J.D. Power & Associates, Kelley Blue Book, Edmunds, et al.), and the non-profit insurance cooperative, the Insurance Institute for Highway Safety. Add to these policing mechanisms that of regulatory agencies and the likelihood of lawsuits exposing the details of terms, and it should not be surprising that the terms of new auto warranties are among the most tightly policed form contracts of any kind.

¹¹⁹ See R. D. Banker & H. H. Johnston, An Empirical Study of Cost Drivers in the U.S. Airline Industry, 68 THE ACCOUNTING REVIEW 576-601 (1993) (discussing the economics of the airline industry in detail).

Automobile warranties are an obvious candidate for consumers to forego a careful reading. The stakes involved with the purchase of an automobile are high. It is typically the second largest purchase anyone will undertake. Furthermore, cars can be quite dangerous, even when they are operating perfectly. Tens of thousands of people die annually in, and because of, auto accidents.¹²⁰

In addition to the high stakes involved, competition for new car sales in most market segments is quite fierce. Even for many luxury cars, the artificial regulatory limitations on the types of vehicles available in various markets creates a closed set of choices for those blessed with resources to buy at the top of the market.¹²¹

When the stakes are so high, and the market for each class of car is so competitive, it is not surprising that each and every term of every auto warranty has been picked carefully apart by the marginal consumer. In fact, when a new entrant to a market seeks to establish itself, it often tries to compensate for its lack of reputation by enhancing its warranty terms beyond the equilibrium standard warranty settled upon by other manufacturers. The best-known example of this has been the Kia Motors Corporation, headquartered in Seoul, South Korea. When it entered the American market in 1994, Kia attempted to distinguish itself by offering a 10-year, 100,000-mile warranty, far longer than the standard warranty offered by other manufacturers.¹²² Kia's strategy was to compete on a margin other than price, trusting that the marginal consumer would lead the way for others.

The rational ignorance with which new car buyers can dismiss new car warranties should not be taken to imply that consumers should take the same approach to a completely different but seemingly related product, namely, the extended warranty. There is a substantial body of literature on the economics of extended warranties, and virtually all of it suggests that they are, for the most part, a bad bargain for consumers.¹²³ Furthermore, "extended warranties are better instruments for product differentiation than manufacturers' warran-

¹²⁰ The Insurance Institute for Highway Safety reports the death toll from auto accidents in the United States in 2013 (the most recent year for which statistics are available) was 32,719. See Insurance Institute for Highway Safety General statistics, available at <http://www.iihs.org/iihs/topics/t/general-statistics/fatalityfacts/state-by-state-overview>.

¹²¹ The State of California, for example, places heightened emissions restrictions on vehicles sold and operated within the state, thereby limiting the types of cars available to would-be purchasers. See California Health and Safety Code §§ 43150 – 43156 (limiting all vehicle registration applications to automobiles demonstrating compliance with California emissions control standards). See also California Department of Motor Vehicles webpage, "Buying A Vehicle From Out-of-State: Can You Register It In California?" available at https://www.dmv.ca.gov/portal/dmv/?1dmy&urile=wcm:path:/dmv_content_en/dmv/pubs/brochures/fast_facts/ffvr29

¹²² See Amanda C. Haury, *5 Of the Best Auto Warranties*, Investopedia.com, (Jan. 30, 2013) <http://www.iihs.org/iihs/topics/t/general-statistics/fatalityfacts/state-by-state-overview> (noting that "All in all, Kia offers one of the most attractive warranties on the market").

¹²³ See, e.g., Sook He Choi, *Analysis of the Automobile Extended Warranties' Market* (August 1999) (unpublished Ph.D. dissertation), 100-01 (noting that the markets for automobile extended warranties are determined demographically).

ties.”¹²⁴ This means that they enable sellers to create enough differentiation so as to price or term discriminate, or both. With market segmentation through differentiation, sellers of extended warranties can defeat the term-policing mechanism of the marginal consumer. In short, consumers need not read new car warranties, but should carefully scrutinize, or forego altogether, extended warranties.

5. Laundry, Parking, and Other Bailment-For-Mutual-Benefit Receipts

Markets involving low-wage labor are low-wage for a reason, namely, the labor involved is so undifferentiated that it is commonplace and therefore easily substitutable. This has always been true for the labor involved in most bailments for mutual benefit, including things like laundry and parking. A bailment for mutual benefit is one where the bailor entrusts property to another, the bailee, under circumstances where both benefit.¹²⁵ Typical bailments for mutual benefit include laundry receipts and parking lot stubs. In the case of a laundry receipt, the bailee-dry-cleaner accepts the article of clothing from the bailor-customer, and promises to perform services upon it that will result in the article being cleaned. In exchange for this cleaning, the bailor-customer promises to pay for the services performed upon the article entrusted to the bailee-dry-cleaner. The bailor-customer hands the bailee-cleaner the article of clothing, and the bailee-cleaner hands the bailor-customer a numbered receipt, usually with a scribbled description of the clothing on the front, and always with extensive terms and conditions on the rear.

This type of bailment is classified in the common law and statutes as a bailment for mutual benefit because both parties to the transaction expect to benefit from it.¹²⁶ The customer expects a service, namely, cleaning, while the cleaner expects payment. At no time does the customer think that she is surrendering title to or ownership of her property, and at no time does the cleaner

¹²⁴ IZZET SAHIN & HAKAN POLATOGLU, QUALITY, WARRANTY, AND PREVENTATIVE MAINTENANCE 14 (1998). *See also*, Lucy Lazarony, *Beware the Extended Warranty Add-On*, Bankrate.com (Jan. 11, 2005) <http://www.iihs.org/iihs/topics/t/general-statistics/fatalityfacts/state-by-state-overview>. (noting "Most new cars have such a great warranty that you don't need an extended warranty," says Remar Sutton, president of the Consumer Task Force for Automotive Issues.).

¹²⁵ A bailment-for-mutual-benefit is to be distinguished from the other two types of bailments, namely, a bailment for the benefit of the bailor ("Hey, can you hold this for me?"), or a bailment for the benefit of the bailee ("Do you mind if I use this today?"). The common law establishes very long-standing, but different, standards of care for each of the three types of bailment. *See* JAMES SCHOUER, THE LAW OF BAILMENTS: INCLUDING PLEDGE, INNKEEPERS AND CARRIERS, 4 (1905). Although a bailment can arise without a contract ("gratuitous bailments"), bailments for mutual benefit typically involve an underlying contract, for which the various types of familiar forms have evolved. For this reason, these are the only types addressed within the scope of this Article.

¹²⁶ *Id.*

think that he is taking title to or ownership of it either. This change of possession without ownership is what distinguishes a bailment from other transfers of property.¹²⁷

In tens of millions of such transactions, particularly between repeat customers and their preferred cleaners, barely any conversation relating to the underlying contract ever takes place. The parties may exchange niceties about the weather, or perhaps comments about current events, sports teams, or politics. But contract terms? Never.

Nevertheless, it is safe to say that most people are untroubled by the fact that they are probably both bound by the terms on the back of the laundry receipt, and the fact that they never discussed them with the cleaner. Virtually everyone has enjoyed uneventful relationships with their neighborhood cleaners. When these relationships turn eventful, the competitive nature of the industry will either cause the cleaner to relent, or the customer to take her business elsewhere. In either case, the terms of the receipt are unlikely to matter much. Even where they do not reflect the demands of the marginal consumer for cleaning, the terms that are actually enforced do.

Like dry-cleaning receipts, parking lot claim stubs are form contracts detailing the terms of a particular type of bailment for mutual benefit. The car owner finds a safe place to temporarily store his car, while the parking lot owner receives payment for providing the temporary storage space. Unlike the laundry bailment, however, the parking bailment typically involves the further complication of an additional party, namely, the auto insurer.

Auto insurance does not alter the underlying terms associated with the bailment contract printed on the back of the claim check. But it does provide an additional reason why the owner of the car is unlikely to focus time and attention on the fine print. In the unlikely but occasional event that a casualty is sustained, the auto insurer indemnifies the car owner, and becomes subrogated to his rights under the bailment contract.¹²⁸ At this point, a large, sophisticated company—whose primary business involves writing and litigating contract language—becomes the party in interest on the bailment contract.¹²⁹

This is not to say that a third-party-payer, like an insurer, substitutes for the marginal consumer. Indeed, the marginal consumer of such contracts may consist of car parkers, as well as insurers. When a parking lot is competitive on both location and price, then terms will begin to matter. To the extent that terms become outrageous outliers, the ultimate payers—the insurers—are likely to become actively involved in reigning in offending lots.

Credit card agreements, mortgage documents, airline tickets, and bailment receipts are only a small, representative sample of the sea of form con-

¹²⁷ *Id.* at 5-6.

¹²⁸ See ROB MERKIN AND JENNY STEELE, *INSURANCE AND THE LAW OF OBLIGATIONS*, 97 (2013) (“[T]he core subrogation remedy enables an insurer who has indemnified its assured to bring proceedings on its own account but in the name of its assured.”).

¹²⁹ *Id.* at 98.

tracts for which it is perfectly rational for consumers to forego the time and effort to perform a close reading. As demonstrated, any consumer who actually bothered to conduct the cost-benefit analysis would quickly determine that the time and effort necessary to read and understand these commonplace forms would soon discover that most of them already reflect their desired terms. This is because *for each term, a marginal consumer, for whom that term is all-important, has insisted upon it.*

B. *Form Contracts For Which We Can Probably Take Our Chances*

1. Tickets for Sporting Events and Entertainment

Radin cites, in passing, the language on the reverse side of ballgame tickets as an example of the abusive degradation and impairment of rights suffered by fans when they purchase and use their event tickets.¹³⁰ Indeed, tickets to a baseball game are not, at first glance, typical of the types of forms for which we might imagine ourselves aided by the efforts of the marginal consumer. After all, except in cities like Chicago, New York, Los Angeles, or those in the San Francisco Bay Area, most baseball fans are captive audiences of only one major league team. Even in those few cities with more than one team, the choices are further differentiated by league and rules; no true “National League” fan could fully enjoy or appreciate a major league game played on the South Side of Chicago.¹³¹

The problem with this perception is the opposite of the problem with perceptions of credit card markets. Just as credit card markets are understandably perceived too broadly, the market for entertainment tickets and their forms are often perceived too narrowly to appreciate the work of the marginal consumers diligently policing on our behalf.

With entertainment, as with other markets, the key question is “what do consumers view as substitutes for the good or service in question, such that consumption of one reduces willingness or ability to pay for the other?”¹³² From this perspective, baseball games and the teams that sell them realize that they are competing with lots of other discretionary spending opportunities for most consumers. Egregious, unexpected, and unreasonable terms on the back

¹³⁰ Radin, *supra* note 4, at 7.

¹³¹ Although many professional sports leagues will consider locating two or more franchises within one city, they do so in recognition that the two franchises do not provide exact substitutes for each other. Furthermore, they make considerable efforts to avoid “cannibalization” of each other’s market share. For an economic analysis of this very point, see Karl W. Einolf, *Location, Location, Location? Sports Franchise Placement in the Four Major U.S. Sports Leagues*, in *THE OXFORD HANDBOOK OF SPORTS ECONOMICS: ECONOMICS THROUGH SPORTS VOL. 2* (Leo H. Kahane & Stephen Shmanske eds., 2009).

¹³² For an explanation of the relationship between substitutes and the elasticity of demand, see Landsburg, *supra* note 2, at 100.

of a ticket, therefore, could render events like baseball games wanting for attendees.

Considered more closely, however, it seems quite rational that consumers might trade off certain rights, including the rights to have expensive medical bills paid, in exchange for relatively cheap bleacher seats. Why might one forego the right to sue for medical bills? Well, how often does even the most frequent guest at a baseball game get seriously injured by a “thrown or batted ball or broken or thrown bats” while attending a game?¹³³ The occurrence is so infrequent, and the odds are so slim, in fact, that the trade-off is, even with precise actuarial calculation, a quite rational one.

Furthermore, some states bar an injured spectator from bringing suit, even in the absence of ticket language limiting liability. Pennsylvania, for example, has a “no duty” rule for sports facility operators and franchises, when a spectator is injured in the normal course of a game.¹³⁴ Nevertheless, very serious injuries have befallen spectators at sporting events, and the ticket clauses limiting liability have been upheld to deny relief to the injured.¹³⁵ The real question is whether the choice to take the risk is a rational one. Given the very small probability of injury, in most cases, it is.

2. Software “Shrink-wrap” and “Click-wrap” Terms.

Perhaps the prototypical “contract of adhesion” in the minds of Radin, Korobkin, Bar-Gill, and others suspicious of form contracts and their drafters, is the ubiquitous “shrink wrap” agreement or “terms of use” accompanying virtually every software application, digital content, website, or other conven-

¹³³ The quoted language appears on the reverse of all tickets to Major League Baseball games. For an analysis of injuries acquired by spectators at Major League Baseball games, see ROBERT M. GORMAN & DAVID WEEKS, *DEATH AT THE BALLPARK: A COMPREHENSIVE STUDY OF GAME-RELATED FATALITIES, 1862-2007* (2008).

¹³⁴ See *Loughran v. The Phillies*, 888, A.2d 872, 876 2005 PA Super 396 (holding that “a spectator at a baseball game assumes the risk of being hit by batted balls, wildly thrown balls, foul balls and in some cases bats.”).

¹³⁵ Recently, a 54-year-old woman was struck in the head by a foul ball off of the bat of Chicago Cubs shortstop Starling Castro at Pittsburgh’s PNC Park, when the ball hit the netting behind home plate as she was standing with her back to the field. Her husband was seated next to a doctor, who treated her before she was rushed to the hospital. Fortunately, she is recovering from the blow. See, John Schmitz, *Just Like The Ticket Says, Foul Balls Are A Hazard*, PITTSBURGH POST-GAZETTE, (April 21, 2015), available at <http://www.post-gazette.com/sports/pirates/2015/04/21/Pirates-fan-hit-with-foul-ball-released-from-hospital-pittsburgh/stories/201504210161>. On the day that Pittsburgh’s Three Rivers Stadium opened in 1970, a woman was hit in the eye by a ball during the Pirates’ batting practice as she stood in a concourse, a hallway leading to the field. She sued, and the case went to the Pennsylvania Supreme Court (which happens to sit in Pittsburgh). The Court affirmed a trial court ruling that awarded the woman \$125,000 in damages. The justices ruled that the Pirates’ ticket language only protected them from liability in “common, frequent and expected risks of baseball,” which it said did not include being hit by a ball while on an interior walkway. *Jones v. Three Rivers Management Corp.*, 483 Pa. 75, 394 A. 546 (1978).

ience or device of the modern world. The most common circumstance under which we encounter these terms of use is when purchasing or downloading digital content. Almost everyone has had the experience of clicking “I agree” without reading any of the language by which we are to be bound.

Under the standard economic analysis, this could be a dangerous situation. Most of the circumstances under which we click agree are ones where the content provider has established considerable market position and has even created conditions or gained substantial information by which it can make distinctions between consumers—it can price and term discriminate. Apple, for example, collects significant amounts of information about each of its customers in its iTunes Store to be able to make suggestions about what music one might prefer.¹³⁶ That information could be aggregated and, at some point, used to determine precisely what terms might “slip by” in a personalized “terms of use” package opportunistically crafted specifically for the specific customer. Apple also happens to have a “captive” customer base, with proprietary software and hardware so incompatible with alternative platforms that switching costs for users are considerably high. This is particularly true for anyone who has invested in a large iTunes library. This is precisely the nightmare scenario envisioned by Bar-Gill.¹³⁷

While the conditions are ripe for opportunistic contract-drafting, the unwitting iTunes user is probably not unwise to simply “take her chances” with the Apple license agreement. This is for two reasons. First, while each of the products Apple sells to each iTunes user creates a unique profile, it is unlikely to be cost effective for Apple to craft “customized” contracts for each user. So, if Apple chooses to use one standard “terms of use” for all or even most customers, there will be marginal consumers for each of the terms in such a form as to make their policing available to aid both classical-music-lover and hip-hop-listener alike.

Second, even if Apple were to customize terms of use for each iTunes customer, how large are the stakes? Perhaps an unwitting customer will learn that the song she purchased and embedded on five devices must now be purchased yet again to put it on a sixth device.¹³⁸ “Another \$0.99 down the drain!” It is true that micro-revenue strategies like the one suggested here have gar-

¹³⁶ See *11 Effective Strategies Apple Uses To Create Loyal Customers*, COMPARE BUSINESS PRODUCTS (Apr. 30, 2009), <http://www.comparebusinessproducts.com/briefs/11-effective-strategies-apple-uses-create-loyal-customers>; but see *Apple Accused of Selling Customer Information*, RUSSIA TODAY (Jan. 22, 2014), available at <http://www.reuters.com/article/2015/03/26/us-uber-netherlands-raids-idUSKBN0MM1LW20150326>.

¹³⁷ See Bar-Gill, *supra* note 5, at 762.

¹³⁸ Apparently, the decision to contract the number of devices a customer can associate with one account was seruptitiously inserted into a change in the iTunes license agreement in 2011. See Trevor Sheridan, *Apple Quietly Updates iTunes Policy To Reduce The Number Of Authorized Devices Per Account*, APPLE NEWS (Aug. 8, 2011), http://applenapps.com/apple_news/apple-quietly-updates-itunes-policy-to-reduce-the-number-of-authorized-devices-per-account.html#.VUZZImZeG8A.

nered immense wealth for many, many companies.¹³⁹ The tiny individual harm to which a consumer exposes herself under these circumstances, however, is not worth the considerable time and effort required, in most cases, to avoid it.

In short, just click “I agree.”

3. Cruise Ship Tickets

Any discussion of form contracts must include a visit to the notorious case of *Carnival Cruise Lines v. Shute*. Recall that the Shutes never had a chance to read the terms of the ticket before purchasing it, although they did, in the course of the litigation, acknowledge that they had notice of the terms, and waived this point on appeal.¹⁴⁰ Also recall the outrage and legislation that ensued, even though the Shute Amendment allowing suit in any court, despite choice of forum clauses, was repealed.¹⁴¹ The case is now enshrined in virtually all first-year law school Civil Procedure and Contracts textbooks, and has been labeled as one of the worst Supreme Court decisions in history.¹⁴²

Cruise products are obviously much more differentiated than airline tickets. Cruise ship tickets and passengers can be segregated by multiple classes of service, decks, exposures, perquisites, and along many other dimensions. As a result, cruise lines are in a much better position to price and term discriminate. This opportunity for term and price discrimination should, according to the analysis outlined earlier, caution any potential cruise passenger to carefully peruse the terms. In general, this would be well-advised. But cruise tickets are unlike airline tickets in that the marginal consumer for each segment within each class get a lot of help from *ex ante* intermediaries and *ex post* litigation publicity.

Given the history of contract terms contained in cruise ship tickets, one might expect that they receive a lot of scrutiny. And they, in fact, do. Besides the marginal consumer, many intermediaries work tirelessly to review and rate the value received by cruise passengers. Several travel magazines, in fact, rate cruises and cruise ships on several dimensions, including cleanliness.¹⁴³

In addition to the *ex ante* policing afforded by multiple intermediaries, cruise passengers are also “protected” by an industry of lawyers and legal ser-

¹³⁹ See Erick Schoenfeld, *For Chinese IM Portal Tencent, the Money is in the Microtransactions*, TECHCRUNCH (Mar. 27, 2008) <http://techcrunch.com/2008/03/27/for-chinese-im-portal-tencent-the-money-is-in-micro-transactions/>.

¹⁴⁰ See Shute, *supra* note 50, at 602.

¹⁴¹ See Reynolds-Naughton, *supra* note 62, at 5.

¹⁴² See Linda S. Mullenix, *Carnival Cruise Lines, Inc. v. Shute: The Titanic of Worst Supreme Court Decisions*, 12 NEV. L.J. 549 (2012) (asserting that the outcome of the case was unjust).

¹⁴³ Websites rating cruises include: www.CruiseCritic.com, www.fodors.com, CNN Travel, www.cruises.com, US News Travel, www.traveltruth.com, www.cruiseline.com, and many more. Magazines performing annual ratings of cruise lines include Travel & Leisure, Conde Nast Traveler, Porthole, and Cruise Traveler Magazine,

vices arrayed to sue the cruise industry on behalf of passengers, individually, or as classes.¹⁴⁴ This *ex post* policing of cruise ship ticket terms has the effect of bringing legal pressure to bear on cruise operators and their terms. If any contract language is going to be carefully pored-over by a court, it will be the language on the back of a cruise ticket. If that language generates an outrageous result, the army of intermediaries will be sure to inform the world of potential cruise passengers of the dangers that lie ahead with the particular cruise line to have drafted the form. Of all of the contracts into which we might enter, few have received as much attention and scrutiny as those on the back of a cruise ship ticket.

The heightened attention and scrutiny devoted to cruise ship tickets does not substitute for the reliable benefits generated by the marginal consumer in markets for competitive goods and services. The considerable attention does, however, reduce the risk that something on a cruise ship ticket will turn out to be a shocking surprise. Potential passengers then, can probably bring magazines, novels, or other casual reading material as they set sail on an unread ticket to paradise.

C. *Form Contracts We Definitely Ought To Read*

As explained above, in competitive markets, the policing of both price terms and can be entrusted to the marginal consumer for each. But not all markets are competitive. While there are many types of contracts consumers do not need to read, and a host of others for which they can take their chances, there are yet other form contracts which consumers probably ought to read before putting pen to paper. In the “ought to read” category are form contracts where the market for the underlying good or service is characterized by monopoly, oligopoly, or monopolistic competition. As competition decreases, we should not be surprised to see non-price terms in form contracts inadequately policed by a marginal consumer, *ex ante* media publicity, or the threat of legal action *ex post*. The absence of competition creates opportunities for firms to craft forms that take advantage of the absence of competitive pressure, and in turn, their customers. Indeed, there are many such circumstances where consumers are well-advised to take the time to carefully read the terms of the form contracts to which they might be bound. These include any forms containing the terms for specialty items lacking substitutes, and any contract written by lawyers for the Disney Corporation (or other entertainment industry companies). This list is admittedly not very long, but that is because it encompasses contracts whose subject matter, by definition, defies categorization.

¹⁴⁴ Many law firms specialize in maritime plaintiff litigation against the cruise industry, with websites designed to inform potential clients of developments in the law. For an example, see CruiseLawNews.com, published by the Miami, Florida firm of Walker & O’Neill, available at <http://www.cruiselawnews.com/articles/worst-cruise-line-in-the-world/>.

1. Contracts for Specialty Items

Contracts for unique goods and services place consumers afloat on the tide without the aid of a marginal consumer to guide them safely to shore. By definition, a good or service that is unique cannot easily be compared to substitutes because there are no substitutes. Where there are no substitutes for a good or service, a consumer cannot easily shop around or compare features and benefits. As a result, there cannot be a marginal consumer for each term—price or non-price—of the contract.

Contracts of this type are ones for which a consumer places a distinct subjective value upon the subject matter at the heart of the transaction. To be sure, every transaction involves parties placing subjective value upon the subject matter. In every contract, each party values what they are getting more than they value what they are giving up. But in many, if not most, contracts where a substitute is at the ready, each party realizes that failure to consummate a deal is not the end of the world. Cover can be effected.

This is not true where the subject matter of the contract is unique. By definition, such transactions are characterized by an absence of ready substitutes—an absence of cover. This absence of alternatives may lead one or more parties to place a heightened or emotional value on the subject matter of the exchange. In other words, where the subject matter of the contract is unique, it is understandable that one or both parties to the exchange may place a heightened subjective value on it. In such circumstances, the judgment or efforts of a marginal consumer are unavailing because *there is no one—no marginal consumer—who feels the same*.

Examples of contracts involving heightened subjective value include those for works of art, plastic surgery, and adoptions.¹⁴⁵ In each case—and this is anything but an exhaustive list—consumers are likely to have an interest incomparable to those held by others. There is no one else similarly situated. There is no marginal consumer to protect against one-sided terms.

As a good or service becomes less and less unique, meaning, as substitutes for it emerge over time (as commonly happens to many monopolies), the concomitant competition generates marginal consumers for each term, including non-price terms. With more competition, consumers are afforded more protection from one-sided terms.

¹⁴⁵ Traditionally, under the common law, contracts for which the subject matter is unique can be specifically enforced, since the mere payment of money damages would not adequately compensate a victim of a breach for whom the subject matter had heightened subjective value. See Alan Schwartz, *The Case for Specific Performance*, 89 YALE L.J. 271, 276 (1979) (explaining the history of specific performance of a remedy for breach of contract at common law).

2. Informed Consent (Medical Treatment) Disclosures

Of all of the documents we are handed to sign, few are as important as the ones informing us of the medical treatment we are agreeing to undergo. As significant as these may be, these “informed consent” documents are typically handed to us when we are at our most vulnerable. Who, after all, would decline care as we are being wheeled into an emergency room or operating theater? Nevertheless, these are precisely the types of documents we probably ought to take a few moments to read.

There may be consumer “watchdogs” and patient rights advocates who pay very close attention to the terms of informed consent documents in the context of medical treatment. It would be a mistake, however, to rely upon these stalwarts for protection. This is for two reasons. First, each medical procedure falls into the category of a “specialized” or “unique” good or service for which the consumer-patient holds substantial subjective value. There is no marginal consumer standing in the breach.

Second, these documents are called “informed consent disclosures” for a reason, namely, they are required by law in circumstances where there exists a large information asymmetry.¹⁴⁶ The prototypical example of an information asymmetry is the gap in knowledge between a medical patient-consumer and the care-provider.¹⁴⁷ The purpose of the disclosure is to place the patient-consumer in a position of making a meaningful decision about the treatment to be received, and, in particular, the risks associated with such treatment.¹⁴⁸ Ideally, the patient-consumer will actually learn something from the disclosure, even if that information does not alter the ultimate decision. The legally-forced knowledge transfer designed to reduce the information asymmetry, however slightly, cannot take place in the first instance unless the patient actually reads the disclosure.

To be sure, the law does not force the disclosure of knowledge whenever there is an information asymmetry. To the contrary, *all* contracts involve an information asymmetry of some sort. The person who sells you a sandwich has no idea of how hungry you are, or that you would be willing to pay twice as much for the same sandwich. (If she did know this about you, perhaps she would price discriminate against you.) Furthermore, information is costly to discover and divulge.¹⁴⁹ A party to a contract is generally deemed to have a proprietary right to any information or knowledge within their possession,

¹⁴⁶ See JESSICA W. BERG, PAUL S. APPLEBAUM, CHARLES W. LIDZ, & LISA S. PARKER, INFORMED CONSENT: LEGAL THEORY AND PRACTICE, 41-6 (2nd ed. 2001) (explaining the theoretical underpinnings for why the law requires informed consent in certain settings).

¹⁴⁷ *Id.* at 42.

¹⁴⁸ *Id.*

¹⁴⁹ See Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Organization*, 62 AM. ECON. REV. 777, 778-79 (1972) (explaining the economics of the costs of information).

without any duty to disclose it to others, including those with whom they contract.¹⁵⁰

But society has deemed some information asymmetries as so undesirable that it imposes, by law, a duty on the part of the one with critical information to disclose to another that information in order to enter into a transaction or relationship. In many settings, like that of the medical procedure, the assent obtained after the required disclosure is deemed “informed consent.”¹⁵¹ This appellation distinguishes this type of consent from all others by indicating it was obtained after the legally required disclosures were made.

Society then, through law, deems the information provided in an informed consent disclosure so important that the transaction is unenforceable without the provision of the information. Since information is costly, the forced dissemination of it is, in effect, a wealth transfer. Not reading the disclosure is, in very real terms, “leaving money on the table.” Nevertheless, countless patient-consumers forego the reading of these forms, even though they will be bound by their terms.

This discussion, like all of the foregoing discussions regarding the types of forms with which we are routinely confronted, leaves aside the normative question as to whether informed consent disclosures *ought* to be enforceable, whether as an agreement, or to effect an estoppel in a tort or contract action against the care provider. Legislatures and medical ethicists continue to wrestle with this question.¹⁵² This article leaves that fight for another day. For purposes of the present discussion, the goal is to identify those forms with which we are routinely presented, and ought to read. The foregoing analysis suggests that informed consent disclosures belong squarely in the “ought to read” box.

3. Short-Term “Pink Slip” and “Payday” Loan Agreements

Unlike the markets for unsecured credit cards (yes, “markets,” not “market”), the markets for secured, high-risk sub-prime lending is much narrower. These markets, for a variety of reasons, are much less competitive than other forms of lending. Indeed, in many states (and ways), these transactions are not loans at all. In many instances, they are title transfers, requiring little or no credit analysis. A “Pink Slip” lender, for example, makes an extension of cash in exchange for the “borrower’s” automobile title. If and when the borrower

¹⁵⁰ See, e.g., *Heritage Ins. Co. of America v. First Nat. Bank of Cicero*, 629 F.Supp. 1412, 1415 (N.D. Ill. 1986) (stating that there is “no duty of disclosure exists absent a fiduciary duty or public trust between parties to a transaction.”).

¹⁵¹ The term “informed consent” originated in 1957 in an *amicus curae* brief filed on behalf of the American College of Surgeons in a medical malpractice case *Salgo v. Leland Stanford Jr. University*. See Eric Pace, *P. G. Gebhard, 69, Developer Of the Term ‘Informed Consent’*, THE NEW YORK TIMES (Aug. 26, 1997).

¹⁵² For a discussion of the ethical and legal debates surrounding informed consent, see RUTH R. FADDEN & TOM L. BEAUCHAMP, *A HISTORY AND THEORY OF INFORMED CONSENT* (1986).

fails to pay, the car securing the loan can be “repossessed.”¹⁵³ Similarly, a payday “loan” is actually an advance on wages. At the time of the extension of the cash, the borrower authorizes the withdrawal of the principal and interest from the borrower’s bank account at the designated future date, namely, the payday.¹⁵⁴

Unfortunately, there are very limited alternatives for low-wage, poor-credit-score borrowers. Accordingly, these markets tend to be anything but competitive. In keeping with the analysis above, such markets are ones where we might expect the margins for suppliers to reflect either oligopoly power or monopolistic competition. In such a scenario, we should not be surprised to see one-sided non-price terms to accompany the one-sided price (interest rate) terms.

Strangely, these market conditions are not necessarily natural ones. Some of what we witness in these markets are the unintended consequences of regulatory efforts to “protect” the low-income borrowers affected. As regulators heighten the requirements for providers of credit to low-wage, poor-credit-score borrowers, they erect barriers to competitive entry by other suppliers.¹⁵⁵ These barriers “shield” entrenched providers from the discipline imposed by competition. But rather than encourage an increase in payday and title lending operators, the legislative and regulatory trend over recent years has been in the opposite direction. The belief that reducing the number of payday lenders will in turn reduce “exploitation” of the poor is a misplaced one.

4. Anything Written By Lawyers for Disney (and Similar Lawyers)

The Walt Disney Company is a large, multinational media conglomerate with many businesses, primarily engaged within and around entertainment industries.¹⁵⁶ To the extent that Disney is an entertainment company, one might presume that the foregoing analysis regarding entertainment ticket terms might apply to it. And to the extent that Disney and its subsidiaries or affiliates participate in markets characterized by heightened competition, this is generally true. But Disney appears to have recognized that, for many of its

¹⁵³ See Jim Hawkins, *Credit on Wheels: The Law and Business of Auto-Title Lending*, 69 WASH. & LEE L. REV. 535, 535 (2012) (describing the process and market for “pink slip” or car title loans).

¹⁵⁴ See Ronald Mann & Jim Hawkins, *Just Until Payday*, 54 UCLA L. REV. 855 (2007) (explaining the characteristics of the ‘payday’ loan industry). See also Todd Zywicki and Robert L. Clarke, *Payday Lending, Bank Overdraft Protection, and Fair Competition at the Consumer Financial Protection Bureau*, 33 REV. OF BANKING & FIN. LAW 235 (2013).

¹⁵⁵ See Todd Zywicki & Astrid Arca, *The Case Against New Restrictions on Payday Lending*, 64 MERCATUS POLICY 209 (2013) (describing the consequences to the poor of limiting access to payday loans and lenders).

¹⁵⁶ The overview of the Walt Disney Company can be found at its official company website, available at <http://thewaltdisneycompany.com/about-disney/company-overview>.

products and services, it operates in markets where it has established, through its marketing efforts and intellectual property, substantial market power. In turn, and in recognition of its market power, Disney appears to have adopted an incredibly aggressive strategy with regard to the terms within its form contracts. In fact, for many of its form contracts, Disney may be said to have the most one-sided terms “throughout the universe.”¹⁵⁷

The foregoing claim is an intended pun, playing upon the language that has evolved, over time, within the Disney Terms of Use associated with virtually all Disney content. This language has evolved dramatically over the past twenty years. Originally, the Disney Terms of Use for its characters, films, and other products prohibited their use in derivative works, without regard to where those works were made, used, or sold. The language originally restricted use of Disney images “anywhere in the world.”¹⁵⁸ At some point, an entertainment industry lawyer (no one seems to know precisely who) decided that this clause did not offer enough protection. Apparently, when the limits of this phrase were pointed out, the language was then changed to prohibit use “anywhere in the universe.”¹⁵⁹ Not to be outdone, later entertainment industry lawyers are credited with the development of the current language, which prohibits use or transfers rights “anywhere in any universe in perpetuity.”¹⁶⁰

While it may be fashionable to pick on Disney lawyers, the truth is that today, virtually all entertainment companies have adopted the Disney language. Indeed, many entertainment lawyers may operate under the belief that this language is expected—required—even if they do not know of its origin and history. The rationale, apparently, is that entertainment media can involve extraterritorial satellite transmission. The “universe” terms in entertainment license agreements and terms of use are reportedly in contemplation of *extra-terrestrial*, as well as extraterritorial rights issues.¹⁶¹ While the imposition of rights in far-off galaxies may not be an issue at the moment, entertainment lawyers are primed for the future.

The example, however, is illustrative of a particular type of legal culture to which Radin alludes. As Radin puts it, some lawyers will include language, even if they do not know or believe it will be enforceable or enforced. They include the language, in some cases, to dissuade lawsuits in the first instance,

¹⁵⁷ The quoted language is taken from the Walt Disney Internet Group Terms of Use, dated November 6, 2003, at 2 (on file with the author). For an interesting survey of the variety of “universe” and “perpetuity” terms in entertainment industry contracts, see Dionne Searcey & James R. Haggerty, *Lawyerese Goes Galactic as Contracts Try to Master the Universe*, WALL ST.J., (Oct. 29, 2009), available at www.wsj.com/articles/SB125658217507308619.

¹⁵⁸ The “anywhere in the world” scope of the Disney user agreement has made a return with its claim on a license to user generated content. See Disney Terms of Use, available at <http://disneytermsofuse.com/english/> (“you grant us a non-exclusive, sublicensable, irrevocable and royalty-free worldwide license.”).

¹⁵⁹ See Gordon Firemark, *Is ‘Throughout the Universe’ Contract Language Broad Enough?*, Firemark.com, (Oct. 29, 2009) <http://firemark.com/2009/10/29/is-the-universe-enough/>.

¹⁶⁰ See Walt Disney Internet Group Terms of Use, *supra* note 157, at 2.

¹⁶¹ See Firemark, *supra* note 159, at 1.

and in the second, to take the chance that some court somewhere might actually grant their wish. According to Radin,

[E]ven if a firm is less than confident that a court would enforce its clauses if they were challenged, it might reason that the attempt was worth trying: "It can't hurt to stick this in. It might prevent someone from suing us, if indeed someone were to read it. And nothing bad is going to happen to us if we use an unenforceable term. At worst, some court will declare it unenforceable, but it will still probably work against other recipients. Might as well give it a try."¹⁶²

The "Disney" approach to legal drafting presents a problem, particularly in those markets where the conditions are less than competitive. In such situations, consumers are at heightened risk of falling prey to opportunistic non-price terms, not because such terms are not policed by intermediaries and social media, but because the lawyers drafting such language are indifferent to the risk that their attempts might be discovered.

In this way, we might even think of this approach to form drafting and non-price terms as analogous to "Giffen" good pricing.¹⁶³ In economics, a "Giffen" good is a good that is atypical because the demand for it actually *increases* as its price increases.¹⁶⁴ We can think of designer handbags and shoes as examples of this. If the price was to drop, consumers would shun the Giffen good, because of the loss of status or signal of quality associated with the formerly high price.¹⁶⁵

In a similar vein, lawyers adopting a "scorched-earth" "Disney" approach to non-price contract terms may draft such terms to demonstrate their "toughness" and market power. This, in turn, might make the company more attractive, certainly to investors, but perhaps also to consumers who take the terms as a signal that they should be happy that the Disney Company is willing to accept their paltry, unworthy dollars as supplication.

Such a stance certainly deters suit, particularly when the drafters are willing to vigorously defend the company's position in court. A strategy like this with respect to terms of use is simple: you may win, but it will be a pyrric victory.

CONCLUSION

Consumers can afford to remain ignorant of the terms of many, if not most, form contracts to which they indicate their agreement. In fact, it is rational for them to allocate their precious time to things other than reading contract boilerplate. When markets are competitive, producers make their prices

¹⁶² See Radin, *supra* note 4 at 13.

¹⁶³ See Landsburg, *supra* note 2, at 85 (distinguishing Giffen goods from "ordinary" goods).

¹⁶⁴ *Id.*

¹⁶⁵ *Id.* at 86. Landsburg actually disputes whether Giffen goods actually exist, although he acknowledges that in theory, they could.

more attractive to lure consumers away from their alternatives. When markets are less than competitive, however, producers can insist upon higher prices and one-sided non-price terms. Within competitive markets, just as the marginal consumer for a price term “polices” the prices of the commodity at issue, so too does the marginal consumer for non-price terms. Such policing is unavailing when the underlying good or service is characterized as unique or differentiated in important ways, reducing the elasticity of demand for it. In such less competitive markets, the marginal consumer proves ineffective at policing terms for infra-marginal consumers.

Accordingly, in markets approaching perfect competition, a rational, infra-marginal consumer can rely on the efforts of the marginal consumer to police non-price terms of form contracts, and need not read the terms to be assured of favorable ones. By the same token, in markets characterized by product differentiation, oligopoly or monopoly, marginal consumers are limited in their ability to protect infra-marginal consumers. Under such circumstances, consumers (and competitors) ought to read terms closely before deciding whether to agree to them.

Despite the rationality of consumer ignorance with respect to form contract terms, scholars, regulators, and law enforcement officials have escalated scrutiny of pre-printed forms as the basis of commercial activity. One important question for researchers is: “Why?” Is there a cognitive bias that compels mistrust of pre-printed forms carefully drafted by teams of lawyers? Perhaps the behavioral law and economics movement has much to contribute in the way of providing an answer to this important question.

NOVEMBER 14, 2014, JLEP SYMPOSIUM COMMENTS
ON
CONSUMER CREDIT AND THE AMERICAN ECONOMY

*Anthony Yezer**

INTRODUCTION

I have been asked to comment on both the text *Consumer Credit and the American Economy* and on the topic itself. These observations begin with some general points about the book followed by specific items that are in text but may escape the casual reader. I conclude with some observations about the thrust of consumer credit regulation being pursued today including its likely effects on the economy.

Consumer Credit and the American Economy

This book provides good coverage of the literature on consumer credit. Unlike many current texts, it traces ideas from origins and shows their evolution as current beliefs. The exposition is accessible to anyone with a knowledge of high school mathematics. This is unusual for an economics text. Tables with time series on the composition of credit, consumer balance sheets, debt burdens, etc., are integrated into the text nicely and provide a valuable resource for someone interested in descriptive statistics.

I would recommend that anyone teaching courses in money and banking, consumer finance, and consumer credit consider adding *Consumer Credit and the American Economy* to the reading list and even making it a required textbook. Courses in law and public policy that deal with contracts in or operation and regulation of consumer credit would also benefit from this book. Attorneys and government officials who deal with these markets will find the book both accessible and informative. Finally, this should be required reading for anyone involved in supplying consumer credit. The book should be read carefully and then used as a fundamental reference on credit issues. The initial careful reading is important because most issues in consumer credit are complex and it may be necessary to consult several separate sections of the text to cover a single issue. This is not a criticism of the way in which the book is organized. It is a consequence of the number of alternative models that can be used to analyze a particular market for consumer credit. The metaphor regarding the necessity of grasping all parts of the elephant also applies to consumer

* Department of Economics, George Washington University

credit as will be evident in the discussion below of material that needs extra emphasis. In sum, my answers to important questions about potential uses of the book are as follows: is it a reference book (strong yes for coverage of the literature); is it a textbook (strong yes, and at \$41 it is a bargain for students); is it a guide for practitioners in the field (another strong yes, and it is nicely indexed for ease of use); will the general public use it (only those who are highly motivated to learn about consumer credit are likely to venture very far into the depths of this work).

Some points that could benefit from more emphasis or discussion are listed below. These are identified because I have found that there is significant confusion about these issues and non-economists reading the book are not likely to pick out answers from the general text.

Why are lenders so specialized?

Non-economists find it strange that lenders specialize in a particular type of credit. Banks lend to a very different group of borrowers than finance companies or payday lenders. In particular, it seems suspicious that there are lenders who concentrate on providing credit to marginal borrowers whose default rates are high. The reason for this specialization is well established in the literature. Underwriting costs are large and no lender can afford to spend large sums screening borrowers who are either very credit worthy or very likely to be rejected. It is very useful in credit markets to have borrowers “self-select” based on their individual credit risk. Consider what would happen if a lender opened an office that provided credit to individuals with credit scores ranging from 850 to 300. The lender would need to establish uniform underwriting methods and apply them to each borrower, carefully documenting why borrowers with debt to income (DTI) ratios of 0.5 were treated differently than those with DTI of 0.1. This would all be very costly. Now imagine that another lender opens and targets low risk (credit score > 700; DTI < 0.2) borrowers. The effort needed to screen these borrowers would be low AND applicants who were unqualified would never apply because of the cost to apply and the likelihood of rejection. Meanwhile the first lender would find that all the low risk applicants were going to the new lender. The net result of this process would be that underwriting costs of the low risk lender and its rejection rate would also be low while the general lender would increasingly only select high risk borrowers and the market would, *de facto*, be segregated by credit risk. The same models work for insurance markets and are standard in economics. Non-economists are unaware that lender specialization is a sign that the credit market is working efficiently, economizing on underwriting effort, reducing rejection rates, and lowering costs to all borrowers. Instead they tend to be very suspicious of the segregation of applicants with different levels of credit risk.

Why do high income borrowers pay less?

Consumer credit is different than most other markets in that high income consumers appear to pay less for the product. In many other areas, food, clothing, shelter, etc., high income individuals appear to pay more for the product. Actually this is, in part an artifact of the way price is measured. High income individuals pay more for their housing but the house is much larger. In fact, price per square foot tends to fall with unit size, but non-economists ignore this. In other areas, high income individuals may pay less per unit of service but they buy more services. Of course, in credit markets, higher income individuals pay less for a number of reasons. First, they generally are better credit risks and so the cost of lending is lower. Second, there are fixed costs to processing a loan and larger loan sizes have lower prices as the fixed cost is spread over a larger loan amount. Third, high income individuals may shop more effectively in part because of greater financial literacy. The return to shopping for credit, as with other goods in services, is lower price. Fourth, high income individuals require less underwriting services. There are several reasons for this, including better record keeping, ability to interact with loan officers electronically, and, very importantly, low probability of rejection. What is the lender's profit on an application that is rejected? The lender loses the cost of application processing. No lender can afford to have a high rejection rate. The problem is that the costs of underwriting and processing applications are not readily observed or documented by lenders. The cost savings of lenders from dealing with high income applicants is often ignored by non-economists.

How has the process of developing consumer credit legislation changed?

While the book presents the economic analysis that supported past changes in consumer credit regulation, it fails to highlight the dramatic change in process in recent years. The Fair Credit Reporting Act was based on the report of the National Commission on Consumer Credit (NCCC) which relied on a host of academic studies. Much of this work was published in peer-reviewed journals. The FTC trade regulation rule governing creditor remedies followed a number of academic studies that were also published in peer-reviewed academic journals. Proposed changes were subject to very careful cost-benefit analysis.

This process from the 1960s through 1990 should be contrasted with more recent regulation of consumer credit where there is virtually no involvement of the academic community. The rather sad process of trying to define a qualified mortgage shows what happens when regulation gets ahead of economic research. No commission study or research effort supported Dodd-Frank legislation and the Consumer Financial Protection Bureau (CFPB) is not advised by independent academic research. It is not even obligated to perform

cost-benefit analysis to support its regulatory initiatives. Goals of the CFPB—eliminating practices that are “unfair, deceptive, and abusive”¹—are not only vague and undefined, they ignore economic efficiency in the form of the requirement that the benefits of this elimination be larger than the costs. They raise the prospect of being achieved by simply eliminating the availability of consumer credit entirely. Elimination would certainly stop unfairness, deception, and abuse but it would likely make millions worse off. The change in regulatory process is implicit in the book but never analyzed as a political phenomenon in which there is no requirement that economic cost and benefit be considered or that high quality research support legislation or regulations.

Behavioral economics is in but financial literacy and numeracy are ignored

There is a nice discussion of the difficulties that non-economists have in making decisions that involve comparisons over time. These difficulties can result in time inconsistencies in the demand for and use of credit. There is nothing wrong with pointing out that some individuals may make suboptimal decisions for these reasons. Recently this type of analysis has been given the name “behavioral economics” and it provides valuable insights regarding the interaction of some consumers with financial markets.

A more significant problem is given very little attention in the text. Most households are financially illiterate and innumerate.² Regardless of issues raised in behavioral economics about ability to form logically consistent programs for use of credit that may afflict a few in some decisions, a far greater number of households simply do not understand the time value of money, the application of probability to choice, the power of compound interest, and are incapable of performing the basic arithmetic to evaluate their financial condition. This is, of course, not a credit market problem. Indeed, these are not primarily consumer credit issues. They reflect massive failure of the school system to teach arithmetic and its applications to consumer financial decisions.³

Failure of the U.S. school system should not be fixed because consumers do not know the relation between points and note rate. It should be fixed because all young people deserve an education and the nation needs educated

¹ Consumer Financial Protection Bureau Strategic Plan FY 2013 - FY 2017, <http://www.consumerfinance.gov/strategic-plan/> (last visited June 22, 2015)

² Annamaria Lusardi & Olivia S. Mitchell, *The Economics Importance of Financial Literacy: Theory and Evidence*, 52 J. ECON. LITERATURE 5 (2014) (providing an extended discussion of the problem of financial illiteracy).

³ Recently the problem of poor financial decision making has been described as a lack of “financial competence” which includes education as one component but experiments indicate that there is an additional necessary component which is based on the willingness to use financial knowledge. See Sandro Ambuehl, Douglas B. Bernheim & Annamaria Lusardi, *Financial Education, Financial Competence, and Consumer Welfare*, (NBER Working Paper 20618, 2014), available at <http://www.nber.org/papers/w20618>.

workers. Nevertheless, if failure of the school system is the problem, it will not be solved by regulating consumer credit. Instead of a Consumer Financial Protection Bureau, there should be an Educational Fraud Prevention Bureau to eliminate the educational fraud being perpetrated by the school system, perhaps making it illegal to award high school degrees to the innumerate and financially illiterate. Nevertheless, in the proposal section below, I will comment on what should be done about consumer credit while we wait for the school system to produce numerate and financially literate citizens.

What is the alternative to shopping with credit?

The NCCC documented and analyzed the alternatives to shopping with credit. At that time usury rate ceilings were very important in limiting low income access to credit. The alternative was shopping at retailers who provided goods and services with no credit charge. Naturally these retailers charged far more than the stores used by the middle class, but there was “free” credit. A couch that could be purchased for \$400 by middle class households was sold or leased with an option to buy in return for twelve convenient monthly payments of \$50. These merchants repossessed goods aggressively if the payments were not made but there was no extension of consumer credit. According to recent press reports, lease-to-own furniture stores are the fastest growing area of retailing thanks to recent regulations that have substantially reduced low income household access to consumer credit.⁴ Indeed, consumer rentto purchase has become an object of increasing concern for state legislatures and even prompted Congressional interest. However, non-economists tend not to see the connection between consumer credit regulations, and rising use of rent-to-own.

Presumably the CFPB can count this as a success because it does not matter if these lease-to-own merchants are unfair, deceptive, or abusive because they do not provide credit. The thrust of the NCCC was that the best way to protect low income households from purchasing shoddy merchandise at high prices was for them to have access to credit so that they could shop in the same stores which were serving middle class buyers whose attention to quality and price would provide a market solution to unfairness, deception, and abuse of the customer. The book includes a discussion of the existence of merchants who incorporate credit cost in the price of the product but the implications for low income households are, in my view, not made clearly enough for the average reader.

⁴ See, e.g., Jayne O’Donnell & Michelle Walbaum, *Rent-to-Own Stores Thrive During Recession*, USA TODAY (Jul. 11, 2009), <http://abcnews.go.com/Business/story?id=8047215>

What about borrower and employee fraud?

The book lacks an extended discussion of the importance of borrower and employee fraud, sometimes linked in the form of organized criminal activity, and the problem that this creates in low income credit markets. For lenders serving low income borrowers, fraud can be a particular problem that, inevitably, raises the cost of lending to this group. In the recent housing market price decline, approximately 15% of subprime defaults were “early payment defaults” or EPDs. This is a euphemism for loans where the borrower never made a payment—i.e., fraudulent loans that may have been secured with the cooperation of loan officers. Lenders have limited incentive to pursue cases of employee fraud. Loan officers can simply move from one location where they were discharged to another lender and resume their activities.

Fraud enforcement against low income applicants, loan officers, and even appraisers, benefits legitimate low income borrowers, not the lenders, because losses are made up in higher fees and rates. This connection is difficult for non-economists who tend to see enforcement efforts benefiting firms who request help. Some detailed discussion of this enforcement problem would have been useful. There is an excellent discussion of the possible consequences of restricting creditors’ remedies that makes the connection to interest rates on consumer credit but the fraud enforcement issue is overlooked.

What is the effect of shopping on consumer credit markets?

Economists have identified the “noisy consumer” who does not shop as a source of higher prices and shoddy merchandise in markets. The same applies to credit markets. Borrowers who shop for credit discipline lenders by rejecting offers of high rates, fees, and/or onerous terms. The need to design a consumer credit system that facilitates shopping for consumer credit should be emphasized. This is the topic of suggestions below.

In the current environment, regulators generally ignore the importance of shopping. This reaches its limit in fair credit enforcement where regulators and plaintiff’s attorneys take the position that there should be no relation between personal characteristics and interest rates. But any demographic characteristic correlated with shopping behavior will also be associated with lower interest rates because that is what shopping does. If shopping did not result in lower rates, no one would shop. Of course, this immediately prompts fair lending enforcement or action by plaintiff’s attorneys against the lender. The net result is for lenders to take actions that discourage shopping and to raise the cost of credit for everyone.

In sum, shopping for credit by financially literate borrowers provides benefits for those who fail to shop by lowering prices and encouraging fair dealing. But shopping also tends to produce racial disparities in pricing that reflect disparities in financial literacy. Regulators more concerned with dis-

parities than prices promote regulations that lower the welfare of all borrowers.

Are consumer credit policies logically consistent with other government policies?

The book documents the responsible use of consumer credit, even at the high interest rates of payday loans, by showing that individual circumstances may warrant borrowing for short time periods at very high rates. Furthermore, it establishes that many borrowers use high cost credit successfully in that they repay in good order and then do not borrow again. It also suggests that the alternative of dealing with unregulated, black market lenders (loan sharks) is not at all desirable.

However, it does not relate government policy regarding high cost credit to other public policies. For example, governments promote investment in lottery tickets, particularly by low income individuals. In this case, the individual invests \$1 and her expected return is only \$0.60. This is a far worse rate of return than would be achieved by taking a payday loan for 30 days and investing the funds in treasury bills and then repaying the payday loan. Both investments have negative returns but the government sponsored lottery has the lower return. Currently, FHA promotes borrowing for home purchase that exceeds the value of the loan (borrowers can finance 97% of appraised value and also finance improvements to be performed in the future). Both the lottery and FHA are actively promoted as part of public policy toward low income households at the same time that subprime credit cards are discouraged. While the book concentrates on public policy toward consumer credit, issues of logical consistency with government programs in general, would provide a useful perspective.

What might we change about consumer credit markets?

Two changes to improve outcomes in consumer credit markets follow directly from the above discussion. First, perform professional, academic quality, cost-benefit analysis of all current and proposed regulations. This should be a primary task of the CFPB with OMB oversight. Second, education reform so that students who are financially illiterate and innumerate do not even graduate from middle school, let alone high school. This will require choice and competition in the school system but other economists have already made solid recommendations in this area.

There is one change in consumer credit that has received little attention except among economists specializing in the subject. It is relatively straightforward and could be implemented at very low cost. Accordingly, it has very low cost and potentially high benefit. The change involves public-private cooperation to offer a range of “standardized” consumer credit products. This

would be completely voluntary and lenders could choose not to offer the products, but, if they did, then the products would follow straightforward guidelines. Product standardization of this type is very common in the economy. Homeowners know that bathroom and electrical fixtures are standardized. They can purchase a sink, faucet, toilet, etc. at a plumbing supply store or big box retailer and be confident that their purchases will “fit” into the plumbing in virtually any home built in the past 50 years. This standardization could be applied to consumer credit products. Two examples, credit cards and mortgages, are discussed below.

The standardized credit card

A standardized credit card would have terms that were all a function of two numbers, the APR and the maximum credit limit. All charges, late fees, etc. would be standardized or be a fixed proportion of the APR and/or credit limit as appropriate. The standardized credit market product would be approved by some government agency but not designed by that agency alone. Instead, an industry committee would design and propose the product. The committee and agency should be advised by high quality cost-benefit analysis performed by competent economists. There could be more than one alternative standardized credit card (for example one with balance transfer provisions and the other without or one designed for prime and the other for subprime borrowers), but consumers must be able to identify and understand the product. Because all terms are proportional to the APR and credit limit, shopping for credit would be possible for financially illiterate and innumerate borrowers because they would only have to compare two numbers.

The standardization would include creditors' remedies, including transferring unpaid balances to third party collectors. Note that no particular positions are being taken here on what these detailed provisions should be. The key point is that they be standardized and all variation in treatment of the borrower would be apparent from variation in the APR and credit limit.

The standardized mortgage

Mortgages are very complex instruments. They are difficult to value, particularly because there are prepayment and default options in effect over a term of 30 years. This means that shopping for mortgage credit is particularly difficult for the average borrower. The standardization proposed here has the same form as that for credit cards. Proposals for the standardized mortgage product would emerge from industry and be approved by a government agency. Lenders would be free to offer only the standardized product, only offer other products, or offer a menu of mortgage products including standardized and differentiated products. The important point is that the standardized prod-

uct be clearly labeled and distinguished by applicants just as FHA mortgage insurance is today.

Lenders offering the standardized product would be obligated to quote an APR for a version of the product with one point as a standardized price. They could then list other alternatives with various point and rate combinations. Other characteristics of the mortgage, such as late fees, would vary in proportion to the APR (on the one point product). There could be a series of fixed rate standardized products and a series of variable rate products. My purpose here is not to identify a specific group of mortgage products to be standardized. This would be the task of the industry and regulators along with economists who would evaluate the product for suitability.

CONCLUSION

Consumer Credit and the American Economy is an important text that has many valuable uses and certainly should be read and mastered by anyone involved with consumer lending or regulation. Given the length of the work, many of the most important points may be lost in the forest of detail and recounting of economic research efforts. I have tried to highlight a few of those issues.

Going forward, it is important to realize that, as chronicled in the text, much of the most important progress in opening consumer credit to the mass of Americans occurred as the result of first rate economic research. This lesson appears to have been lost as current legislation and regulation is proceeding without careful cost-benefit analysis that considers all costs including unintended consequences.

Finally, there are proposals for a different approach to dealing with consumer problems in the pricing and use of credit that are not noted in the text. Chief among these is the possibility of partnerships between government and industry to identify and certify standardized credit products that could be offered to consumers. These products would be structured so that their cost could be understood and compared by borrowers who are financially illiterate and innumerate. Standardization does not prevent borrowers from making bad decisions regarding the use of credit but it allows them to shop based on price and secure terms that are not deceptive and easily compare pricing across lenders. Most important, it allows borrowers to secure credit at low cost rather than be forced into the alternative of the world of lease-to-own, purchase at elevated price, or even black market credit sources which appears to be the direction that the low income borrower is headed under the current regulatory environment.

