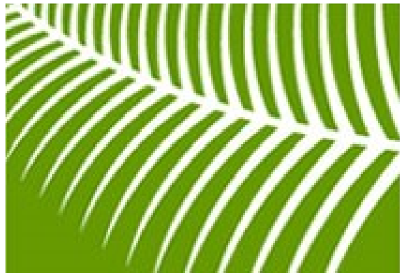

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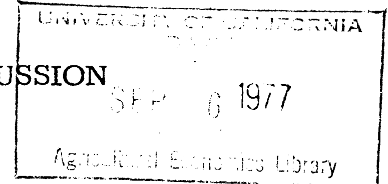
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CONSUMER CREDIT POLICY ISSUES: DISCUSSION

Jean Kinsey*

Dr. Dunkelberg suggests that social legislation is designed to alter an existing income distribution (broadly defined) and that this unsatisfactory income distribution is the result of a successful (efficient) market system. An efficient market system where each factor receives a price approximately equal to value of its marginal product and each market agent acts in his/her own best interest will inevitably create inequities. But it does not follow that existing inequities are the result of an efficient market.

I suggest that the objective function of social legislation is multi-variate in nature and that altering the distribution of income no matter how broadly defined, is but one of those variables. Other variables are concerned with correcting a variety of conditions which prevent the market from functioning efficiently. Still other variables are concerned with ensuring basic human rights and dignity. The trade off between variables enhancing efficiency and those enhancing equity is at the heart of economic policy.

The consumer credit industry is the focus of vast amounts of social legislation and Dunkelberg selected three representative types of regulations to analyze in his paper. Dunkelberg and his colleagues

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have assembled and analyzed an enormous and growing amount of data on the consumer credit industry and on consumer credit behavior. Captured in this data is a potential gold mine of information for policy makers. However, the value of information for policy decisions depends on asking the right questions including whose interests are being served by the answers. Anyone, who analyzes policy affecting consumers, needs to keep in mind how that policy affects consumer's welfare as well as how it changes their behavior. Caution should also be exercised in using terms such as "excessively high rates" or "too low an interest rate". Policy decisions are difficult enough without economists using vague terms where precise definitions exist.

There is no quarrel with the economic analysis nor with the results Dunkelberg has presented. They are totally consistent with what one would expect from economic reasoning and they are consistent with the results of other empirical research on similar topics.[1/] Consequently this discussion will focus on problems associated with asking the right questions by elaborating on some of the basic reasons for social legislation in general and credit regulations specifically.

Interest Rate Ceilings

Outside of perpetuating a long standing tradition one is led to ask why interest rate regulations persist, especially since the predicted and observed results may be inconsistent with economic and social goals. One reason, as Dunkelberg pointed out, is to prevent some people from obtaining credit "for their own good." If this is true it implies at least three conditions:

1. The elasticity of demand for credit is no greater for high risk borrowers than it appears to be for low risk borrowers. In other words, given the opportunity to borrow, high risk borrowers will do so, even if it is not in their own best interest.
2. Going into debt will decrease the utility of people who are high risk borrowers.
3. Low risk borrowers have altruistic or paternalistic feelings towards high risk borrowers.

The first implication, a low interest elasticity of demand for consumer credit, is evidenced in part by the existence of a black market for consumer credit and in part by consumer's stated willingness to pay more than the existing rate of interest on short term credit.

The second implication, that going into debt will decrease the utility of high risk borrowers, is not at all obvious. Studies on personal bankruptcies and reports of a close correlation between emotional, marital and financial problems confirm that overindebtedness appears to lead to greatly diminished personal welfare. 2/ However, if bad debt losses are viewed as private income transfers, as Dunkelberg suggests, and these transfers are in the direction which increases equity, then it is possible that the utility of high risk borrowers is not decreased by being in debt, even if they default on their payments.

Recent research has shown that increasing the ratio of installment debt to liquid assets decreases the probability of families feeling worse off [3]. This result held for all income ranges, for both rural and urban dwellers and for debtors as well as the total population. If

borrowers do not perceive indebtedness as decreasing their utility and those rationed out of the market do, in fact, seek credit from a totally unregulated market at much higher interest rates, then interest rate ceilings are not protecting people from themselves. Low rates of time preference for consumption enable borrowers to circumvent interest rate regulations, and the altruistic purposes appear to be negated.

The third implication of continued credit rationing is an altruistic attitude on the part of low risk borrowers. Time does not permit a full application of Becker's economic model of altruism [2] in this discussion, but a brief description will reveal its relevance. He assumes that all behavior results from maximizing utility functions and that the utility function of the altruist contains a vector of his own consumption (X_n) and the consumption of other persons (X_i).

1. $U^h = U^h (X_h, X_i)$ where h is the altruist and i is an egoist. Becker shows that h will transfer just enough income to i so that increases in h's utility will be the same whether the income is spent by himself/herself or by i.

   If low risk borrowers are the altruists (h) and the high risk borrowers are the egoists (i), then h must believe that rationing i out of the credit market, will allow i's consumption to increase. And in the case of rationed credit, h can accomplish all this with no planned transfers of income to i.[3/]

   A slight extension of Becker's model hypothesizes that the utility of egoist i is a function of his consumption vector (X_i).

2. $U^i = U^i (X_i)$

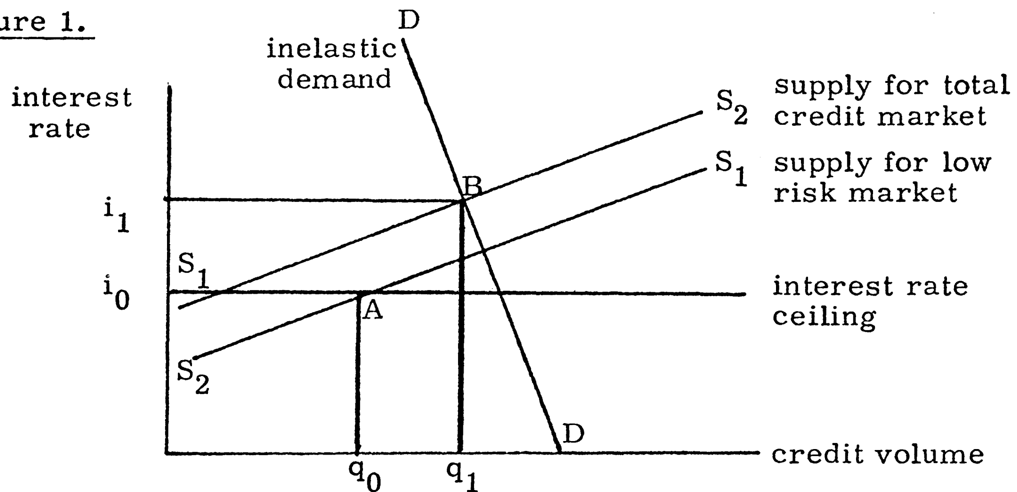
Substituting into equation one the utility of the altruist h now is a function of his/her own consumption and the utility of the egoist i.

3. $U^h = U^h (X_h, U^i)$

Assuming a positive sign on the utility of i, h's utility is decreased when i's utility is decreased. If h believes that permitting credit in i's consumption vector decreases i's utility, then h will endorse credit rationing. However as research discussed above has shown, allowing i to increase his debt-asset ratios does not necessarily decrease i's utility. The altruist (h) could be perceiving an incorrect sign on U^i in his/her utility function. If the sign on U^i is negative, the altruistic h should not be endorsing ceilings on interest rates.

One other reason why usury laws may persist is that low risk borrowers are not altruistic and want to ensure their ability to obtain credit at a low interest rate "for their own good." These people make up the group who are not rationed out of the market by interest rate ceilings and are the primary beneficiaries of such regulation. If the interest rate were allowed to rise to whatever level is necessary to cover the costs of loaning to all potential borrowers, those who are currently borrowing in the legitimate credit market would find themselves paying much higher interest rates. This can be seen easily in Figure 1 where the supply of credit shifts from S_1 to S_2 as the result

Figure 1.



of increased costs due to lending to people from all risk categories. If, simultaneously, interest rate ceilings were abandoned the quantity of credit available would expand to q_1 at interest rate i_1. This model assumes that interest is the only charge for credit. The low risk borrower who at point A is able to get all the credit he wants, can hardly be expected to be happier at point B with higher interest rates. A considerable amount of his consumer surplus will have been taken away.

Dunkelberg made three predictions about the effects of interest rate ceilings. I would like to add a fourth. As long as relatively low risk borrowers who are not rationed out of the credit market are in decision making positions, relatively low interest rate ceilings will continue to be in force. This would probably not be true if decision makers all started in what John Rawls [4] calls "original positions," where they operate in ignorance of their class position in the future society and of their relative standing with respect to assets and abilities. In this idealistic state they would opt for rules which allow individuals to follow their own preferences because that protects their

own future liberties and respect.

Preferences vs. Welfare

In our more realistic state of affairs a fundamental policy question centers around whether welfare is a function of preferences, individually or collectively. If there is a distinction between preference based behavior and welfare then one must ask what factors, other than market failure, interpose between the two. In the case of credit use it may well be factors such as ignorance, uncertainty, evaluation difficulties and preferences which can be distorted by desperation. Such factors inhibit efficient market operation and tend to justify regulatory interference.[4/]

Collection Remedies

Curbing collection practices of lenders is one of several recent credit regulations designed to alleviate factors which intervene between preferences for credit and welfare. An imbalance of market power produced conditions conducive to alleged exploitation and unfair treatment of credit customers. Other examples of recent credit regulations which were designed to alter the balance of market power are the Fair Credit Billing Act, the Equal Credit Opportunity Act, and changes in the holder-in-due-course law. Creditors will incur some additional costs from each one of these regulations and given the existence of usury laws, the available credit can be expected to contract. Dunkelberg provided evidence that this has happened but as he pointed out, the proportion of credit contraction due to protective regulations has yet to be isolated.

Truth in Lending

Truth in lending laws were an attempt to alleviate at least two factors which tended to separate preferences from welfare, namely, ignorance and evaluation difficulties. The extent to which consumers will benefit from this information will depend on their ability and incentive to use it. Dunkelberg has presented exhaustive statistics regarding the knowledge of interest rates and credit charges by various categories of consumers.

The fact that this regulation does not appear to have improved the competitiveness of the credit market is not surprising in the face of interest rate regulations and inelastic demand. On the other hand, this hardly diminished the value of truth-in-lending laws in that they do provide consumers access to relevant information at relatively low cost.[5/] It should not bother anyone that all borrowers have not committed to memory all the interest rates for their current and potential future credit accounts any more than it bothers anyone that consumers of hamburger cannot quote the accurate price of hamburger in all of the local supermarkets. The important point is that the information is available if and when the borrower deems it useful. If low cost information is the consumers' market right the law is justified even if the original objective is negated.

Conclusion

Existing policies with respect to consumer credit seem to imply that most decision makers believe there is a difference between preferences and welfare. Limiting expenditure on credit, especially the expenditure

of high risk borrowers, is viewed as providing a type of merit good. This puts consumer credit in the company of a growing list of other goods, like tobacco, alcohol, marijuana, laetrile, gasoline and most natural resources. I suggest we call these "sumptuary" goods for the very purpose of decision makers is to override personal preferences and reduce spending for such commodities. Sumptuary goods are rationed by various ingenious methods including the informed preferences of some consumers. A key issue still not resolved is whether consumer credit ought to be a sumptuary good. If so, then we need to know how to ration it fairly and more about how this rationing will change individual and collective welfare.

FOOTNOTES

1. For citings of several empirical studies see the reference list in Dr. Dunkelberg's paper on consumer credit policy issues.
2. Personal bankruptcy occurred for .10 percent of our population in 1976 [1].
3. This may negate the definition of being an altruist. See [2, p. 218].
4. However, if one believes that welfare is solely a function of preferences, freedom of choice must be the ultimate goal of economic organization and regulation.
5. Costs here include transaction costs, time costs, frustration, and other costs associated with obtaining information from legal documents or bureaucratic offices.

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