

Interest-Rate Caps—Like Other Price Controls—Harm Consumers

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KEY TAKEAWAYS

Interest-rate caps are price controls, and history has repeatedly demonstrated that price controls do not help the people they are supposed to help.

Price controls destroy the effectiveness of markets and reduce opportunities to prosper. They can also worsen the conditions used to justify them in the first place.

Congress should not impose price controls on credit markets, and should avoid interest-rate caps like those included in the Veterans and Consumers Fair Credit Act.

Government controls on consumer prices—the maximum or minimum that companies are allowed to charge—are nearly as old as recorded history.¹ For just as long, price controls have harmed people, especially those that the controls are supposedly designed to help.² Yet, policymakers continue to promote and implement price controls as a way to help to improve people’s lives.

While trying to help people is a laudable goal, a decentralized price system is a key feature of a free enterprise system that allows people to satisfy their wants and needs better than a system controlled by politicians and bureaucrats who set arbitrary prices. Implementing price controls because some people view certain prices as “too high” does not change this fact. Price controls destroy the effectiveness of markets and ultimately reduce citizens’ opportunities

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to prosper.³ They can be particularly dangerous because they worsen the conditions that policymakers use to justify the controls in the first place. Unsurprisingly, some of the most prominent advocates for price controls are those who benefit the most due to reduced competition.⁴

These realities apply equally to all forms of price controls, including the interest-rate caps that several Members of Congress are now proposing. Interest rates are merely the price that lenders charge borrowers for loans, and price controls have the same harmful effects in credit markets that they have in other segments of the economy. Congress should not impose credit-market price controls, including those in the Veterans and Consumers Fair Credit Act.⁵ If Congress wants to help people to provide and obtain credit more effectively, it should remove the countless regulatory barriers that stifle competition in the financial industry.⁶

Price Controls Harm Those They Are Intended to Help

Market prices represent information on how people value products and services. This information is displayed as objectively as possible, and people use it to allocate (or ration) goods and services based on factors that include their own preferences, needs, and production costs. All else constant, businesses are willing and able to sell fewer goods at lower prices, while consumers prefer to buy more. Similarly, at higher prices, businesses prefer to sell more, but consumers are willing and able to buy less.

Price controls interfere with this process by replacing the price system with government officials' subjective views. That is, rather than allowing consumers and businesses (the market) to allocate resources as objectively as possible, government officials ration goods based on what they think prices should be. Historically, usurping the decentralized price system in this manner has not worked. In the most egregious cases, such as those in the planned economies of Eastern Europe, price controls resulted in pervasive shortages.⁷

Because experience matches the theoretical critique of price controls, economists generally oppose them. For instance, price ceilings create a legal maximum price. They tend to create shortages because business owners are no longer able to charge sufficiently high prices to provide products and services, and because consumers demand more than they would at higher market prices. Price floors, on the other hand, lead to surpluses because they prevent prices from reaching the lower level at which they would naturally settle. At artificially high prices, fewer consumers are willing and able to buy, while businesses are more than happy to sell.

Price controls have many harmful unintended consequences, including bribery and corruption to evade the controls, as well as rent-seeking, which benefits the people implementing the controls, but it ultimately raises costs for consumers and businesses.⁸ Moreover, they cause market distortions that provide additional pretense for more price controls and government intervention, both of which tend to further hinder the effectiveness of markets and decrease overall prosperity. Price controls rarely help the people they are intended to help—*some people* invariably end up with fewer resources than they would have had in a market-based system, and the highest income earners typically suffer the least, while the lowest income earners suffer the most.⁹

Harmful Effects of Interest-Rate Caps

Caps on interest rates (usury laws) are price ceilings imposed to prevent interest rates from rising above an arbitrary maximum. Price ceilings on interest rates, just like price ceilings in other markets, do nothing to limit demand. In other words, while interest-rate caps make it more costly to supply credit, they do nothing to reduce the demand for borrowing.¹⁰ As a result, people develop alternate (more costly) ways of both supplying and obtaining credit, fewer people end up with credit than they would otherwise, and others pay more for the loans that they do obtain.¹¹

State usury laws have their roots in colonial times,¹² and the U.S. has a long and unsuccessful history regarding various types of interest-rate caps. A federal price ceiling on bank deposit interest rates, for example, was a main cause of massive bank disintermediation during the 1970s *and* the 1980s Savings & Loans debacle.¹³ Similarly, prior to a 1978 Supreme Court decision that federally pre-empted them, a patchwork of state usury laws on consumer loans and credit cards restricted competition in these markets. Consequently, companies supplied fewer credit cards and (among other work-arounds) charged annual fees to avoid the rate caps.¹⁴

Latest Federal Attempts to Impose Rate Caps

Many states still have their own usury laws, but these maximum rates typically apply only to relatively small consumer loans, resulting in a relatively limited effect on *most* consumers.¹⁵ Nonetheless, based on the false notion that private short-term lenders tend to “trap” consumers in high-cost debt, many federal officials have been increasing their efforts to restrict lenders’ ability to supply credit.¹⁶ The misnamed 2010 Dodd–Frank Wall

Street Reform and Consumer Protection Act authorized the Consumer Financial Protection Bureau (CFPB) to impose new regulations on these lenders, and it also created a variety of taxpayer-subsidized alternatives to private small-dollar lenders.¹⁷

Congress has imposed these regulations despite the fact that consumers want, need, and appreciate the credit providers in such markets.¹⁸ The combination of regulating private lenders while providing government-financed alternatives to short-term loans all but ensures a long-term reduction in consumer welfare. Congress is also trying to impose widespread rate caps by (among other endeavors) extending the price controls in the Military Lending Act to the broader credit market.¹⁹

Price Controls in the Veterans and Consumers Fair Credit Act

The Veterans and Consumers Fair Credit Act (S. 2833) amends the Truth in Lending Act²⁰ to extend the rate caps (and other restrictions) on certain loans for active-duty military personnel to *all* consumers. These features, enacted by the 2006 Military Lending Act,²¹ forbid providers of *consumer credit* to active-duty service members (and their spouses and dependents) from charging an annual percentage rate of interest greater than 36 percent.²²

Consumer credit, in turn, is defined via regulations prescribed by the U.S. Defense Department. Currently, these regulations define consumer credit as “credit offered or extended to a covered borrower primarily for personal, family, or household purposes, and that is: (i) Subject to a finance charge; or (ii) Payable by a written agreement in more than four installments.”²³ The Military Lending Act also provide several exceptions, such that the rate caps do *not* apply to residential mortgages, automobile loans, or loans for other personal property when that property is used to secure the loan.²⁴ The act applies the interest cap to a rate that includes all fees and charges, including those for single premium credit insurance.²⁵

If Congress enacts S. 2833, the new rate caps would apply to all credit cards, deposit advance loans, overdraft lines of credit, and various installment loans.²⁶ The bill would, however, exempt loans made by federal credit unions. Congress should not impose price controls on credit markets, and it should avoid interest rate caps such as those included in the Veterans and Consumers Fair Credit Act. Price controls force businesses to impose higher costs on consumers and result in fewer people obtaining the goods and services that they need.

Conclusion

The best way to ensure that people get the credit they need is to improve the competitiveness of private credit markets, not to impose a ceiling on the rates that lenders charge. Interest-rate caps are price controls, and history has repeatedly demonstrated that they do not help the people they are supposed to help.

Imposing interest-rate caps, such as those in the Veterans and Consumers Fair Credit Act, will restrict the supply of credit for those who most desperately need it, and ultimately raise the cost of credit for many other borrowers. Enacting price controls on such a widespread basis will worsen problems in credit markets, thus bolstering a false pretense for more price controls and government-provided credit. This policy route will ultimately increase people's dependence on government and prevent them from prospering.

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Endnotes

1. Hugh Rockoff, "Price Controls," in David Henderson, ed., *The Concise Encyclopedia of Economics* (Indianapolis, IN: Liberty Fund, 2008), pp. 409–412.
2. Minimum-wage laws, for instance, tend to result in employers offering fewer low-wage jobs, upgrading their hiring standards, and reducing benefits (including on-the-job training) for those low-paying jobs that they do still offer. See David Neumark and William Wascher, *Minimum Wages* (Cambridge, MA: MIT Press, 2008); Richard Ippolito, "The Impact of the Minimum Wage if Workers Can Adjust Effort," *Journal of Law and Economics*, Vol. 46, No. 1 (April 2003), pp. 207–227, <https://www.jstor.org/stable/10.1086/374706> (accessed July 26, 2021); Harry Holzer, Lawrence Katz, and Alan Krueger, "Job Queues and Wages," *Quarterly Journal of Economics*, Vol. 106, No. 3 (August 1991), pp. 739–768; Ekaterina Jardim et al., "Minimum Wage Increases, Wages, and Low-Wage Employment: Evidence From Seattle," NBER *Working Paper* No. 23532, May 2018, <http://www.nber.org/papers/w23532> (accessed July 25, 2021); and Rebecca Diamond, "What Does Economic Evidence Tell Us About the Effects Of Rent Control?" Brookings Institution, October 18, 2018, <https://www.brookings.edu/research/what-does-economic-evidence-tell-us-about-the-effects-of-rent-control/> (accessed July 25, 2021).
3. Research demonstrates that "countries in any stage of development can achieve and sustain economic dynamism if their governments adopt economic policies that encourage greater entrepreneurship by empowering individuals and firms with more freedom of action." See "Economic Freedom Around the World: The Key to Human Progress," in Terry Miller, Anthony B. Kim, and James M. Roberts, eds., *2021 Index of Economic Freedom* (Washington, DC: The Heritage Foundation, 2021), pp. 21–31, https://www.heritage.org/index/pdf/2021/book/2021_IndexofEconomicFreedom_CHAPTER03.pdf. Heritage's *Index of Economic Freedom* scores are, all else constant, lower for countries whose governments implement price controls.
4. The Center for Responsible Lending, for example, advocates interest-rate caps on many small consumer loans, and is affiliated with the Self-Help Credit Union and the Self-Help Federal Credit Union, both of which receive subsidized funding to provide loans (both are designated community development financial institutions (CDFIs)).
5. S. 2833, Veterans and Consumers Fair Credit Act, November 12, 2019, <https://www.congress.gov/bill/116th-congress/senate-bill/2833/text> (accessed July 24, 2021), and H.R. 5050, Veterans and Consumers Fair Credit Act, November 12, 2019, <https://www.congress.gov/bill/116th-congress/house-bill/5050> (accessed July 24, 2021).
6. Norbert J. Michel, ed., *Prosperity Unleashed: Smarter Financial Regulation* (Washington, DC: The Heritage Foundation, 2017), <https://thf-reports.s3.amazonaws.com/2017/ProsperityUnleashed.pdf>, and David R. Burton, "Improving Entrepreneurs' Access to Capital: Vital for Economic Growth," Heritage Foundation *Backgrounder* No. 3182, February 14, 2017, <https://www.heritage.org/sites/default/files/2017-02/BG3182.pdf>.
7. Similar problems occurred in the U.S. during the 1970s. See Rockoff, "Price Controls," p. 409.
8. Stephen J. Dubner, "Why Rent Control Doesn't Work (Ep. 373)," Freakonomics Radio, April 3, 2019, <https://freakonomics.com/podcast/rent-control/> (accessed July 26, 2021).
9. Two common examples of harmful price controls are rent control and minimum-wage laws. Rent control normally results in less housing than would otherwise exist, with landlords staying out of the market altogether or neglecting to maintain their properties. Minimum wage typically results in higher wages for those that manage to keep their jobs, but lower levels of overall employment, especially for teenagers and minorities. See N. Greg Mankiw, *Principles of Economics* (Fort Worth, TX: Harcourt Brace College Publishers, 1998), pp. 112–121.
10. Especially in the case of higher-risk borrowers, price caps prevent lenders from charging prices commensurate with their expected loan losses. As a result, lenders who continue to provide loans to such customers must either raise fees on these borrowers, raise rates on other borrowers, or employ another strategy to deal with a lower overall profit margin due to losses. Meanwhile, the price ceiling does nothing to change the underlying economic conditions that drive people to seek loans in the first place.
11. Richard Peterson and Gregory Falls, "Impact of a 10 Percent Usury Ceiling: Empirical Evidence," Purdue University Credit Research Center *Working Paper* No. 40, 1981, <http://citeseerx.ist.psu.edu/viewdoc/download;jsessionid=C0847F93F77CC807A70E075B6EF33055?doi=10.1.1.195.9122&rep=rep1&type=pdf> (accessed July 23, 2021). Depending on the overall policy, it is also possible that a rate-controlled market will result in more credit flowing to people who should not borrow money. That is, even though private lenders have good economic reasons to avoid making certain loans, a heavily regulated or subsidized market with price controls ignores those reasons.
12. Joseph Sanchez, "The Death of Usury, the Democratization of Credit and the Financial Well Being of the American Consumer," SSRN *Working Paper*, March 22, 2011, <https://ssrn.com/abstract=1792769> (accessed July 24, 2021).
13. Randall Kroszner and Philip Strahan, "Regulation & Deregulation of the U.S. Banking Industry: Causes, Consequences and Implications for the Future," National Bureau of Economic Research, March 2013, <https://www.nber.org/system/files/chapters/c12571/revisions/c12571.rev2.pdf> (accessed July 24, 2021), and Robert J. Laughtlin, "Causes of the Savings and Loan Debacle," *Fordham Law Review*, Vol. 59, No. 6 (1991), p. S301, <https://ir.lawnet.fordham.edu/cgi/viewcontent.cgi?referer=https://www.google.com/&httpsredir=1&article=2929&context=flr> (accessed July 24, 2021).
14. Todd Zywicki, "The Economics of Credit Cards," *Chapman Law Review*, Vol. 3, No. 79 (2000), pp. 95–105, https://www.chapman.edu/law/_files/publications/CLR-3-todd-zywicki.pdf (accessed July 24, 2021), and Robert Clarke and Todd Zywicki, "Payday Lending, Bank Overdraft Protection, and Fair Competition at the Consumer Financial Protection Bureau," *Review of Banking and Financial Law*, Vol. 33 (2013–2014), pp. 268–271.

15. The maximum rate, as well as the loan amount to which the maximum rate applies, varies by state depending on characteristics of the lender, the borrower, and the type of transaction. See State Interest Rate Laws, 2021, <https://statelaws.findlaw.com/consumer-laws/interest-rates.html> (accessed July 24, 2021). Also see Richard Hynes and Eric Posner, "The Law and Economics of Consumer Finance," *American Law and Economics Review*, Vol. 4, No. 1 (Spring 2002), pp. 168–207, <https://www.jstor.org/stable/42705407> (accessed July 24, 2021).
16. Norbert J. Michel, "Dodd–Frank and the Consumer Financial Protection Bureau Put Squeeze on Private Payday Lenders," Heritage Foundation *Issue Brief* No. 4479, November 4, 2015, <http://thf-reports.s3.amazonaws.com/2015/IB4479.pdf>, and Norbert J. Michel, "Government: We Must Destroy Payday Lenders Because Americans Are Stupid," *The Daily Signal*, October 9, 2015, <https://www.dailysignal.com/2015/10/09/government-destroy-payday-lenders/>.
17. *Ibid.*
18. Kelsey Bolar, "Here's How Low-Income Americans Feel About the Obama Administration's New Lending Regulations," *The Daily Signal*, December 20, 2016, <https://www.dailysignal.com/2016/12/20/heres-how-low-income-americans-feel-about-the-obama-administrations-new-lending-regulations/>.
19. Another example is Representative Alexandria Ocasio Cortez's (D–NY) and Senator Bernie Sanders's (I–VT) proposal to federally cap annual credit card interest rates at 15 percent. See Gregory Krieg, Katie Lobosco, and Ryan Nobles, "Bernie Sanders and Alexandria Ocasio-Cortez Team Up on Credit Card Interest Rates," *CNN*, May 9, 2019, <https://www.cnn.com/2019/05/09/politics/bernie-sanders-aoc-credit-card/index.html> (accessed July 24, 2021).
20. 15 U.S. Code § 1631 et seq.
21. 10 U.S. Code § 987.
22. 10 U.S. Code § 987(b).
23. 32 CFR § 232.3(f)(1).
24. 10 U.S. Code § 987(i)(6), and 32 CFR § 232.3(f)(2).
25. 10 U.S. Code § 987(b). S. 2833 does include exceptions to fees for credit extended via credit cards, but the *annual percentage rate of interest* is as defined in Section 107 of the Truth in Lending Act, meaning that it is defined in regulations prescribed by the CFPB (15 U.S. Code § 1606, and 12 CFR § 1026.22).
26. See National Credit Union Administration, Military Lending Act (MLA), July 19, 2021, <https://www.ncua.gov/regulation-supervision/manuals-guides/federal-consumer-financial-protection-guide/compliance-management/lending-regulations/military-lending-act-mla> (accessed July 24, 2021).