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AN ECONOMIC PERSPECTIVE ON INTEREST RATE LIMITATIONS

Thomas A. Durkin[†]

INTRODUCTION

It is my pleasure today to have this opportunity to speak to such an august gathering of attorneys about a 4500 year old economic question, the efficacy and usefulness of price controls in financial markets. Most of the historical, as well as present, concern in this area involves interest rate ceilings on credit, which will be the focus of most of my remarks. Much of what I say, though, pertains equally well to other financial controls such as deposit rate ceilings. Consequently, I am discussing those other controls at the same time, even if I do not seem to address them as specifically or extensively.

There is an old joke about economists, most often repeated by economists themselves, that if you laid all members of the profession end to end, they would reach halfway to the moon but they still would not reach a conclusion. Please let me assure you that this old saying does not reflect economists' views about interest rate ceilings; they long ago reached a conclusion on that question. I suspect Nobel Laureate Milton Friedman spoke well for the entire profession in 1970 when he reported, "I know of no economist of any standing . . . who has favored a legal limit on the rate of interest that borrowers could pay or lenders receive—though there must have been some."¹ In a pithy 1982 comment on controls, former Chairman of the President's Council of Economic Advisors Paul McCracken suggested a reason why: "The list of people who made the sun stand still does not contain many names after Joshua, and the list of those who successfully commanded interest rates to stand still is even shorter."²

[†] Board of Governors of the Federal Reserve System, May 1, 1991 (revised May 8, 1991). Presented at the American Bar Association, Section of Business Law, National Institute on Consumer Financial Services in the 1990's, Mar. 2, 1990. The views expressed are those of the author and do not necessarily reflect those of the Federal Reserve Board, its member Banks, or its staff.

1. Milton Friedman, *Defense of Usury*, NEWSWEEK, Apr. 6, 1970, at 79.

2. Paul W. McCracken, *Congress Gets a Joshua Complex*, WALL ST. J., Sept. 24,

My purpose today, however, is not to review or summarize the views of interest rate observers (economists or otherwise), but rather to focus on the reasons for the profession's unanimous or near-unanimous conclusion. This discussion forms the first part of my remarks. Following this I will briefly review two additional arguments about interest-rate ceilings which are more philosophical than economic in nature. Although there is more divergence in the economics profession on the philosophical arguments than on the economic ones, many economists find the philosophical arguments against ceilings compelling as well. Next, I will quickly look at and criticize some arguments occasionally advanced as favoring price ceilings. Finally, I will briefly examine some principles to follow if there is a decision to establish ceilings anyway, despite the strength of the contrary arguments. As part of this last discussion, I will only mention some red herrings and economically tangential issues, such as the question of state versus federal authority, which economists usually regard as sideshows.

I. ECONOMIC ARGUMENTS AGAINST PRICE CONTROLS

Economists list four major objections to price ceilings or controls, each sufficient by itself, it seems, to recommend elimination of binding controls: A) controls create shortages; B) controls reduce competition; C) controls waste resources; and D) controls have adverse impacts on the macroeconomy including negative impacts on employment, output, and income.³

A. *Controls Produce Shortages*

In the nineteenth century Thomas Carlyle called economics the "dismal science" when he wrote about Thomas Malthus's theories of population growth and inadequate food supplies (still a concern today). It seems possible in the late twentieth century, however, that the phrase sticks in many minds because of the tendency of economists to derive things that sometimes seem intuitively obvious using assumptions, axioms, theorems, rules of deductive logic, and even equations and esoteric branches of

1982, at 34.

3. I will use the terms "price (or interest rate) ceilings" and "price (or interest rate) controls" interchangeably throughout this discussion. There may be some other contexts in which the terms are not synonymous.

mathematics in the process. One of these derivations is the so-called "Law of Demand" which (without worrying here about the assumptions or the deductive processes) suggests simply that quantity demanded of anything varies inversely with price, other things equal. Thinking of credit, this means that at a lower price borrowers will demand more (other things equal) and at a higher price, less. Maybe the amount demanded will be a little more at a lower price and maybe a lot more, but it will certainly be as much or more at a lower price and not less.

Conversely, we might contemplate a corresponding "law" of supply. Again without worrying about the behavioral assumptions, the mathematics, or the details of the derivations, this component of theory derives the intuitively obvious conclusion that producers offer more of a product at higher prices, other things equal. Again thinking of credit, this suggests that amounts offered will be greater at higher interest rates, other things equal, a contention that seems reasonable on its face. Taking both "laws" together, supply and demand suggest the likelihood that there must be some price (high, low, or in between) at which demand just equals supply. This is the equilibrium or market price (interest rate for credit markets) at which trading (lending and borrowing) take place. It may vary over time depending on demand and supply conditions.

Obviously, of course, things are not this simple in the real world. Users show by their actions that they demand lots of different financial and credit products and suppliers provide lots of varieties. There are size, production cost, security, and risk differences, and many other complications as well. Still, the simple conception remains useful: for each credit product or variety in the marketplace there is a demand, a supply, and an equilibrium price at which trading (borrowing and lending) takes place. There may be higher or lower interest rates depending on production cost, risk, and degree of interaction with other credit submarkets, but the basic supply-demand framework remains useful regardless. In each credit submarket supply and demand conditions, which may vary sharply between submarkets, determine an equilibrium or trading price.

One of the complications that arises is the possibility of legislatively mandated rate ceilings or controls. Interest rate ceilings are as old as recorded history; historians have found them in the ancient Laws of Manu in India, the Code of Hammurabi in Babylon, the Old Testament, and the statutes of

ancient Greece and Rome.⁴ The ancient laws and writings contain two main threads: A) somehow, lending is not productive and therefore there should be controls on its price; and B) borrowing occurs because the borrower has great need and so charging a price for it is uncharitable.⁵ Ancient scholars and medieval schoolmen developed both ideas more fully and their influence survives today, albeit with diminished influence in this commercial age.

Rather than origin, however, the pertinent question about rate ceilings and controls is their impact. The "laws" of supply and demand give the answer. If officials establish an interest rate ceiling that is below the rate (price) at which demand equals supply for a particular credit type, then there is a shortage of that type of credit. At a price below the equilibrium price the amount demanded (which increases at lower price) then exceeds the supply (which decreases at lower price). By definition if demand exceeds supply at a given price there is a shortage. The market response would be a price rise to equate demand and supply, but the rate ceiling precludes an increase and the shortage persists. The situation is analogous to the gasoline lines of a few years ago. Mandatory price controls on gasoline created a situation where price could not equate demand and supply. At the artificially low price demand exceeded supply resulting, by definition, in a shortage and leading to the gasoline lines. Eventual removal of the price controls allowed higher prices to decrease the amount demanded, increase the amount supplied, and quickly eliminate the shortage and the lines.

There is, however, one big difference between credit and gasoline lines: the nature of the rationing device. In the gasoline case the available supply goes to those first in line, those lucky

4. See SIDNEY HOMER, A HISTORY OF INTEREST RATES.

5. For example, Leviticus said:

And if thy brother be waxen poor, and fallen in decay with thee; then thou shalt relieve him; yea, though he be a stranger, or a sojourner; that he may live with thee. Take thou no usury of him, or increase; but fear thy God; that thy brother may live with thee.

Leviticus, 25:35-37. The passage "take thou no usury of him, or increase" is the ancient meaning of usury: any interest at all. Thus, the Biblical stipulation "take thou no usury" produced a zero percent rate ceiling to meet the requirements of charity. Deuteronomy contains a similar injunction: "Thou shalt not lend upon usury to thy brother; usury of money, usury of victuals, usury of anything . . . unto a stranger thou mayest lend upon usury; but unto thy brother thou shalt not lend upon usury." *Deuteronomy*, 23:19-20.

enough to arrive at the right time, those willing to tolerate waits, or even to the relatives and friends of gasoline station owners or those willing to pay bribes.⁶ In the credit case rationing would more likely be governed by adjusting risk acceptance rather than by choosing those chronologically first in line. In particular, creditors would reject outright those borrowers they believed to be risky, eliminating them from the applicant line. Second, creditors undoubtedly would also adjust nonprice aspects of the credit offer, such as by requiring larger down payments or equity, shorter maturities, and more collateral. Both kinds of action would generate selective impacts on the population of borrowers. Likely losers would be newer, younger, or otherwise less well known borrowers: small businesses and farms, less financially stable firms and consumers, and those demanding small amounts of credit where the production cost is high per dollar of loan. Creditors might also impose fees and raise uncontrolled aspects of the price and eliminate or reduce grace periods and collect more quickly and more vigorously.

On occasion interested observers dispute the argument that interest rate ceilings cause credit shortages, contending instead that there is plenty of credit around despite the ceilings. What, of course, they are really saying is not that economic theory is wrong, but rather that the ceilings are not binding—they are set above the supply-demand equilibrium rate and so are not constraining the market at that time. Saying, for example, that there is plenty of credit card credit available despite rate ceilings says nothing when the ceilings are far above market rates (as they should be to prevent shortages). The question is what happens when ceilings are below the supply-demand equilibrium rate. Those are the ceilings that cause shortages.

6. In the long run it is not clear that gasoline price ceilings would reduce the price even to those who do obtain the supply. Waiting in line is costly in terms of time wasted and it seems likely that those with a high value of time would begin to hire those with a lower time value to do the waiting. "Line waiting" or "car sitting" services likely would form (indeed, teenagers were beginning to form them in 1979). Also, sellers likely would begin to institutionalize bribery in the form of black markets. The effect would be higher prices (including the line waiting or black market fees), up enough ultimately to equate demand and supply but with the price difference going into the pockets of middlemen rather than suppliers. Thus, since there would be no incentive for suppliers to increase production, price would have to rise relatively more to equate demand and supply than if the price ceiling were simply removed in the first place.

Thus, shortages and rationing that selectively affect certain population segments and classes of borrowers are the economic result of interest rate controls that impede the convergence of supply of and demand for credit. Is this a problem? Certainly, some people hold the view that consumers and maybe businesses as well would be better off without credit. If credit were not so readily available, according to this view, credit users would be better able to practice self denial, to avoid overburdening themselves with debt, and even possibly to save a little more. This view completely overlooks economic experience which shows that most borrowers use credit responsibly and, more importantly, for productive purposes.

Neither consumers nor businesses borrow, after all, for the purpose of wasting the resources, and unlike the debtors contemplated in *Leviticus* and *Deuteronomy* they do not, by and large, borrow because of distress. Rather, most borrowing in a modern economy occurs for investment purposes. Consumers invest in homes, durable goods like automobiles and appliances, and durable services like education and medical care. Each of these forms of capital provides a flow of returns over time in the form of valuable consumer services. Consumer capital is analogous to business capital like factories, machines, and equipment which provides investment returns over time to business. By investing in capital goods and services both consumers and businesses can raise total returns available from their resources and increase the level of their real wealth. Interest rate ceilings interfere with this process by restricting credit availability and potentially lowering the real wealth of those rationed from the market. By itself, this a strong indictment of controls.

Controls and shortages also ruin the usefulness of markets in indicating that changing conditions warrant changes in quantities demanded and supplied—in the jargon of the profession, controls destroy market signals. If rate ceilings hold interest rates below the free market level, there is no signal to savers that more funds are needed or to borrowers that less credit demand is appropriate. High interest rates signal the need for smaller amounts of credit demand and larger amounts of supply, but nonprice rationing hides this information and continues the shortage. Markets can transmit information about the need for change, but only if controls do not interfere with the effectiveness of the dynamic signals.

B. Controls Reduce Competition

Cloudy signals discourage potential suppliers from entering the market. In effect, price controls become a barrier to entry. With controls in place, potential entrants have little enthusiasm for the market or for increasing supply. But, free entry is a prerequisite for competitive conditions in markets.

The benefits of competition in markets are well understood, but they bear repeating because they are often overlooked. First, competition assures that products or services, including credit, are available to those who demand them at minimum production cost for the quantity and quality of service. Thus, competition produces efficiency. Second, free competition reduces potential conflicts of interest and concentrations of power that, along with higher prices, are the hallmarks of uncompetitive markets. As soon as substantial barriers to entry are put in place, the competitiveness of markets begins to deteriorate and the benefits of competitive markets to decline. As competitiveness ebbs, prices rise, the quality of service declines, or both. Interest rate ceilings and controls produce a barrier to entry and reduce the likelihood of competitive conditions.

C. Controls Waste Resources

If the bad news is that controls cause shortages and impede competition, the good news is that they are not always fully effective because imaginative people find ways around them. But that is bad news too, because both they and the government waste resources in finding ways around them and in enforcing them. The evasion issue merits a closer look.

Not surprisingly, economists have thought about and studied reactions to regulation. In recent years the field has been very active, and economists have developed interesting economic theories about the origins of, motivation for, and reactions to regulatory change.⁷ One theory suggests that regulation itself is important in generating regulatory change. This theory suggests

7. See, e.g., Theodore E. Keeler, 44 THEORIES OF REGULATION AND THE DEREGULATION MOVEMENT, PUBLIC CHOICE 103-45 (1984); Paul L. Joskow & Roger C. Noll, *Regulation in Theory and Practice: An Overview*, in *Studies in Public Regulation*, (Gary Fromm ed., 1981). More generally, Professor James M. Buchanan won the 1987 Nobel Prize in Economic Science for his theoretical contributions in this area known as Public Choice Theory.

that, in effect, regulation functions as a tax, raising costs. It has the result of making production of regulated services more costly or it raises the cost of entering regulated markets. As a result, in a competitive market suppliers of products are constantly looking for ways around the regulations or are constantly shifting resources from regulated to unregulated ways of doing things. In other words, they are looking for ways to reduce costs.

There is no intent here to imply that the attempt to avoid regulation is a cynical reaction. Very simply, the attempt to avoid regulation is merely a rational economic reaction to business cost pressures in a competitive market. But it does produce constant testing of the frontiers of the regulations themselves. Often these tests and the shifts of resources into unregulated related activities result in new regulations. These, in turn, are tested anew and the process cycles on, giving rise to the descriptive term "regulatory dialectic."⁸ Ongoing regulatory change is costly, however, because of the constant need for operating and procedural upheavals as well as the necessity of devoting considerable resources to the dreaded "L words" of business: lawyers, legislation, and litigation.

Interest rate ceilings and controls seem to be a good illustration of the dialectical process of regulatory change. In fact, to a great degree, most of the legislative and regulatory changes of the past seventy-five years in the consumer credit field, particularly at the state level, have involved price control efforts and reactions to attempted escapes. Clearly, disputes over add-on rates, discount rates, simple interest, and even credit card billing methods involve pricing and reactions to price controls. Likewise, small loan legislation, the time-price doctrine, the Marquette doctrine, dual business restrictions, and even convenience and advantage licensing concern pricing and its control. Controversies over credit insurance, leasing, and rental purchase, by and large, involve credit pricing and control. Furthermore, issues involving real estate points and fees, rule of seventy-eight's refunds, and even disclosure matters such as components and itemization of finance charges are, at least in part, manifestations of reaction to price control. As each of these issues cycles on, the economy continues to pay for our legacy of price controls with each

8. The origin of this term is generally attributed to Professor Edward J. Kane's descriptions of bank holding company regulation.

hearing, legislative change, mandatory operational variation, and lawsuit these issues generate.

It is not possible, of course, to say how consumer credit markets might have developed in this country without the legacy of ceilings and controls, but it seems certain some things would have been different. Probably most of these issues would never have developed. At the least, it seems that much of the cost associated with the regulatory dialectic would have been less, and the economy could have devoted fewer resources to regulatory changes and enforcement efforts.

D. Controls Have Negative Macroeconomic Impacts

Although analysts have not devoted as much time or attention to the effects of financial controls on the macroeconomy, it seems again that the likely impact is dismal. First, by keeping interest rates below their free market equilibrium rate, interest rate ceilings reduce savings. Second, by reducing savings the ceilings also keep borrowing and investment below their free market levels. Third, savings and investment below choice, which implies that resources are engaged in second-best uses, together promise negative impact on output, employment, and income. Inefficiencies associated with regulatory avoidance and enforcement also involve shifts of resources to less effective uses, reinforcing the negative effect. Although no one has measured the actual impact and, indeed, it may not be measurable, there is no reason to suspect anything other than these negative outcomes.

II. PHILOSOPHICAL ARGUMENTS AGAINST PRICE CEILINGS

The economic arguments against price ceilings are not the only telling criticisms. Rather, further arguments, broader in generality, and maybe in appeal to some noneconomists, equally suggest the folly of financial price ceilings or controls.

A. Controls are an Improper Role for Government

A first criticism is that placing controls on the private contracting of lenders and borrowers is not an appropriate role of government in a free society, except perhaps in cases of unquestionably unconscionable behavior by one of the parties. In effect, the issue is whether, apart from clearly unconscionable

conduct, it is the proper role of government to tell individuals they cannot engage in certain activities or transactions when they fully understand what they are doing, they freely choose to do so, when they regard these transactions as beneficial to themselves, and when the activities are harmful to no one. Many people, including many economists, argue this is not a proper role of government, but others disagree. The others apparently take a more paternalistic view, contending, in effect, that the law should not permit borrowers to pay rates above some ceiling, presumably to protect them from themselves. It is possible to apply economic analysis here, too.

There is a widespread myth, perpetuated perhaps by those whose personal resources enable them to provide for their own needs and wants easily, that individual consumers become worse off when they enter into credit agreements. This, of course, is not the case when consumers enter into credit agreements by free choice and there is no deception or unconscionable behavior by the creditor. Consumers choose to enter such contracts because they perceive the benefits to themselves in the form of returns on the uses of the funds, typically assets such as houses, automobiles, education, durable goods, and medical care, but also preferred consumption time patterns, to be worth the cost they must pay savers (usually through financial institutions) to borrow the savers' resources. In the jargon of economics, the net present value is positive. If lives were infinite in length or if needs to purchase houses, durables, and other assets were uniformly distributed over consumers' lives and did not tend to come in bunches, consumers might demand less credit. Lives are not infinitely long, however, and asset needs do come in bunches, typically in the twenty-five to forty-five age brackets. Many people believe that limiting consumers' opportunities to make their own choices does them a disservice.

Beyond this, there is the question whether a few government officials are better prepared to make choices for millions of citizens anyway. Legislators and officials have their own experiences and biases which do not necessarily match the views of all their constituents all of the time. Unsuitability of government's choices together with imagination of entrepreneurs and the fungibility and substitutability of money have produced the regulatory dialectic noted earlier. That path leads to bureaucracy, enforcement, reporting burden, new managerial

efforts to evade, and distortions in resource allocation. These produce a dead-weight loss to society.

B. Controls do not Solve the Identified Problem Anyway

Most significantly, another criticism of interest rate ceilings is that they do nothing to address the problem that inspires them, namely, high interest rates. The level and variation of interest rates depends on broader factors than just conditions in the controlled markets or submarkets. Rather, particular interest rates are under the influence of capital market conditions generally, and these reflect many wider influences ranging from wage rates and inflation rates to resource allocation choices of society and even to world economic conditions. Looking at consumer credit markets alone is not sufficient to understand capital markets or trends in interest rates, including consumer-credit interest rates. And controlling consumer credit rates will not favorably affect capital markets.

Market interest rates consist of a list of components, all of which may fluctuate: a real-return component, an inflation adjustment, a risk adjustment (including a liquidity premium), and an adjustment for fixed costs (if any). The real return is the return that the ultimate lender requires in units of constant purchasing power—a real return of three percent per year, for example. The inflation adjustment, in turn, compensates for money's changing value. If inflation of four percent per year over the life of the credit is expected (in other words money is expected to decline in value four percent per year), then the lender would reasonably require seven percent (three percent real return plus four percent for inflation). Likewise, if the lender expects some losses, then there must be compensation for the losses. If losses of three percent per year are expected, then the lender would require another three percent per year or ten percent in all, considering all three components. Finally, the market interest rate must cover all fixed costs. If the fixed costs are small relative to the loan size (say, on a ten million dollar commercial paper note of a low-risk issuer), the impact on the market rate is almost negligible. In contrast, if fixed costs for credit analysis, payment processing, and regulatory compliance loom large relative to the credit amount, then their impact on the required market rate will be substantial.⁹

9. In 1972, the National Commission on Consumer Finances argued that fixed

The point of all this is that high or fluctuating rates result from a variety of factors, not all of which are specific or limited to the type of credit under consideration. In recent history enthusiasm for rate ceilings has most often involved consumer and mortgage credit, of course. But high rates in the former largely arise because of high fixed costs on small credit amounts. Credit costs depend on such things as wage rates, postage rates, and trends in automation and technology. It is not clear that interest rate ceilings favorably affect any of these factors. High rates in the mortgage credit case most often result from higher inflationary expectations and higher market interest rates generally. These may change with the business cycle or even with international developments. It is not obvious what price ceilings could do in these cases, except create shortages.

In sum, rate ceilings and controls are not effective solutions to high interest rates. High interest rates are caused by factors such as operating costs and inflation expectations that are outside the purview of interest rate ceilings. In a large sense interest rates are like a thermometer that measures the economy's temperature. High or rising rates measure economic symptoms and may well indicate economic problems or ills. But controls do not even treat symptoms; they merely do violence to the thermometer.

III. CRITICISM OF ARGUMENTS THAT PURPORT TO SUPPORT CONTROLS

Despite 4500 years of sorry experience with price ceilings on credit, controls still have their supporters. Let us now look at some of their arguments.

A. *High Rates Disadvantage the Needy*

All of the reasons advanced from time to time which purport to support the need for interest rate ceilings and controls all illustrate the above criticism of controls: they are not effective solutions to the problems they are supposed to address. For example, even today some observers argue the ancient and medieval contention that taking interest is wrong because it

lending costs would raise required interest rates for finance company loans as high as 95 percent for the smallest loan sizes. See National Commission on Consumer Finance, *Consumer Credit in the United States*, pp. 141-45 (1972).

involves uncharitableness toward the needy. These people may apply this contention only to interest rates above some low level or only to some kinds of credit or borrowers (low-income consumers, for example). Nonetheless, despite any limitations, the contention is the same: high rates charged at least to some consumers for some kinds of credit are uncharitable or unfair.

Unfortunately, rate ceilings and controls are not an effective remedy to the problems of necessitous borrowers, and controls will adversely affect many others too. As already discussed, most borrowing is not done out of necessity by the needy and desperate, but rather by those who have resources and incomes and who desire to change the time path of their income and consumption flows. These include businesses that borrow current resources for investing in facilities and equipment that provide a greater flow of investment returns, consumers who borrow to invest in assets such as houses, autos, durable goods, education, and health care that provide a greater real wealth. Necessitous or desperate people normally are unable to borrow anyway, and so interest rate ceilings to protect them is the wrong remedy to apply to their needs.

This is not the place to discuss proper private or government programs to help the needy, except to say that interest rate ceilings and controls are not among the useful suggestions. Rather, control efforts disrupt commercial activities among the nonneedy without doing anything for those who are desperate.

B. Controls Address the Problem of Unequal Bargaining Power

A second argument is that ceilings are needed to redress unequal bargaining power and keep rates from rising to astronomical levels. But this ignores the forces of competition. An individual creditor is not free to charge an arbitrary price as long as other creditors are charging lower prices for similar services and the public is even partially aware of the existence of alternatives. Today it is hard to argue otherwise. Many credit markets are free of ceilings and prices still fall within relatively narrow ranges across creditors. Residential first mortgage credit, for example, has been free of rate ceilings since passage of the Depository Institutions Deregulation Act of 1980, but the uncontrolled rates are not astronomical. In fact, rates have fallen sharply since 1980, and they tend to fluctuate very sensitively with changes in the economy. Rates in local markets, as revealed

in many newspaper surveys, tend to be quite similar across creditors, even if not exactly the same.¹⁰ While individual consumers may not have great strength of bargaining power individually, they do have immediate and obvious alternatives. The breadth of potential buyers taken together, each of whom individually has alternatives, gives consumers market power of their own, and those who shop for credit can police the market for those who do not. Certainly, it is difficult to argue that monopoly conditions are prevalent in many credit markets today. Rate ceilings or controls could only make the situation worse by establishing barriers to entry.

C. *Credit is a Utility that Government Should Regulate*

A third argument is that credit, and, indeed, financial services generally, are so important today that they should be considered public utilities subject to public direction and price control. But, financial firms are much different from typical public utilities. For one thing, financial firms do not produce outputs like electric power where scale economies and advantages of large size are alleged to be sufficient to drive out competitors and produce a monopoly. Evidence of economies of scale for financial firms is very slight and only then for movement out of the very small firm size classes.¹¹ Furthermore, financial firms do not require the large, fixed capital investments of electric, water, and other public utilities that suggest a public interest in protecting them from competition so they are profitable and the investment is forthcoming. For financial firms monopoly is unlikely and so public action to protect against monopolistic pricing is not needed.

Even if monopoly were likely, however, it is not at all clear that public utility-type regulation would solve problems in the financial area. Public utility regulation typically sets prices in such a way as to provide a reasonable return on invested assets. In the credit area a single price would result in preferred risk classes or loan sizes, most likely large loans to low risk

10. See, e.g., the listing of mortgage rates in the Saturday real estate section of the *Washington Post*.

11. There is a fairly large economic literature on this question. See, e.g., George J. Benston et al., *Scale Economies in Banking*, J. OF MONEY CREDIT AND BANKING, pt. I, Nov. 1982; Thomas Gilligan et al., *Scale and Scope Economies in the Multiproduct Banking Firm*, J. OF MONETARY ECONOMICS, May, 1984.

borrowers. If there were to be multiple prices for different risk classes and loan size with each price supposed to bring a guaranteed return on assets invested in that type of credit, there would be immense difficulties with allocation of joint costs. It seems highly improbable that the bureaucratic mill could provide better answers than free market credit production. In addition, investments in loans and other financial assets are much more mobile than investments in power plants and gas pipelines. If public pricing decisions were inadequate, assets would migrate to other credit markets, other kinds of activities, or even to other countries.

D. Controls Help Avoid Overburdening Consumer with Debt

A fourth argument supposedly supporting the usefulness of price controls on credit is that controls help avoid overburdening consumers with excessive debts. But excessive is, at least to a degree, in the eyes of the beholder. If the objective is to set rate ceilings so that no or few consumers can borrow, this objective will not be consistent with the views, wants, or needs of the affected individuals. If, in contrast, the goal is to reduce credit availability only to those unable to pay, controls seem to be the wrong response. Inability to repay typically arises after the fact due to loss of job, sickness, marital problems, or other personal difficulties. Prior interest rate controls are unlikely to help solve these problems. If in the remaining cases consumer insolvency arises from creditors' lack of information about the financial condition of new applicants, the solution is improvement in information systems and not in interest rate controls that disrupt commercial relations for many others as well.

E. Controls Assure that Consumers Pay "Fair" Rates for Credit

Finally, on occasion rate ceilings are suggested as means of assuring that consumers pay "fair" rates for credit. But, fair for whom? In a competitive market credit transactions can occur only if lenders and borrowers agree that the price is "fair." A regulatory agency can never achieve this match for each of the millions of credit transactions that take place annually. If ceilings make creditors unwilling to generate small amounts of credit or credit to riskier borrowers, for example, then those excluded from the market may not agree that ceilings have made prices "fair" for them. Of course, sales credit might still be

available because merchants could raise prices and use the difference to subsidize the credit losses. Cash buyers might not feel the prices are fair, however, and would shop elsewhere.

The likely result of the rate ceiling would be development of a class of stores which sell credit goods largely to poor risks but at higher prices. The stores would use the excess income on the goods to subsidize the risky credit operation and not earn as high a profit as the high goods prices might otherwise suggest.¹² This would frustrate the goal of achieving a "fair" price (if that means a lower price) for credit and might actually make matters worse because market segmentation would tend to increase and competitive forces to decline. In sum, legislation restraining gross income from finance changes necessitates adjustments in credit availability, fees, goods prices, or some combination. There is no magic way to reduce prices.

IV. DESIGNING CEILINGS

The foregoing should, I hope, be convincing arguments that credit rate ceilings and controls are not good public policy. If ceilings are necessary, nonetheless, perhaps for political reasons, let me suggest a few developmental principles that can help minimize difficulties.

The first principle is, of course, if at all possible, to set ceilings high enough that their sole effect is to eliminate truly unconscionable behavior but not otherwise to interfere with the smooth functioning of the credit markets. Ceilings can serve a useful function if government officials are able to use them as a standard of unconscionability but they do not otherwise impede legitimate commerce. Ceilings might have to be very high for small amounts of credit for short periods. Moreover, the existence of ceilings should not serve as an invitation for establishment of bureaucratic monitoring, reporting, interpreting, and enforcing regimes that submerge the usefulness of an objective unconscionability standard under a mountain of red tape.

Second, ceilings should not vary by type of creditor. Ceilings specific to certain creditors merely make those creditors favor or not favor certain types of credit producing market segments and

12. This result is not hypothetical. See Federal Trade Commission, ECONOMIC REPORT ON INSTALLMENT CREDIT AND RETAIL SALES PRACTICES OF DISTRICT OF COLUMBIA RETAILERS (1968).

barriers to entry. The objective should be to encourage easy access for creditors to all submarkets to discourage market segmentation and tendencies toward monopoly.

Third, for the same reason, ceilings should not depend on the type of goods financed. Some goods may have better collateral value than others, but the main differences in consumer credit interest rates arise from variations in credit size and type of customer rather than collateral differences. Thus, ceilings dependent on collateral type may well induce preferences by credit size and type of customer, again tending to produce segmented markets and greater likelihood of monopoly power.

Fourth, ceilings should employ the same components and definitions as other regulations—including disclosure regulations. It makes no sense, for example, that a percentage rate calculated under the ceiling requirements be some different percentage under disclosure regulations because the components or compounding methods required are different. If they are different, at a minimum the ceiling regulations should be regarded as applying only to ceilings and not to disclosures and vice versa. Neither area should serve as a cause of litigation in the other.

Finally, ceilings should not vary by geographic area or state. A hodgepodge of unrelated ceilings merely serves to complicate the operations of creditors, to make creditors prefer one area over another (tending to segment markets), and to impede the development of efficient credit flows to credit-needy areas. Variations among states eventually causes real resources, including employees, to change locations for artificial, inefficient reasons. Such differences can be, and in fact have been, sources of long and drawn out legal maneuvering and litigation, which economists regard as sideshows to the underlying economic issue of the inappropriateness of controls. Recent acts in the sideshow include questions surrounding the legality of exporting and importing interest rates, concerns over the rights of states versus the Federal government in regulating interest rates, and all the controversial aspects of the so-called “Marquette doctrine.” Rate ceilings that did not vary by geography would make all of these costly problems disappear.

CONCLUSION

In sum, this economist agrees with the unanimous or near unanimous view of the profession: ceilings or controls on interest rates have been a bad idea for a long time and will continue to be a bad idea in the future. Controls create credit shortages, they impede competition, they waste resources, they harm the macroeconomy, they interfere with free choice, and probably most tellingly, they do not work anyway. At the next American Bar Association Consumer Financial Services Ten-Year Outlook Conference we will celebrate the millennium, the coming of the year 2000 and, we hope, a new era. After 4500 years of experience with credit controls, I hope that conference will not have to address this issue when discussing the outlook.