

# “MAXIMUM POSSIBLE ACCURACY” IN CREDIT REPORTS

RICHARD M. HYNES\*

## I

### INTRODUCTION

The Federal Trade Commission (FTC) estimates that twenty-one percent of credit reports contain material errors,<sup>1</sup> and poor credit reports can cause significant harm. Credit reports affect whether consumers get loans and how much they pay,<sup>2</sup> and credit reports are used for more than just credit. Insurers use credit reports to set premiums,<sup>3</sup> landlords use credit reports to decide whether to rent apartments,<sup>4</sup> and both private and public employers use credit reports to determine whom to hire. When the Equal Employment Opportunity Commission (EEOC) sued an employer for considering credit reports, the Sixth Circuit noted that the EEOC itself considered credit reports in filling eighty-four of its ninety-seven positions.<sup>5</sup>

The EEOC is not alone in criticizing the credit reporting industry. States, Senators, and Representatives have taken action aimed at reform.<sup>6</sup> Eleven states and several cities limit the use of credit reports in employment,<sup>7</sup> and Senators Elizabeth Warren and Bernie Sanders have co-sponsored legislation that would

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\* Richard M. Hynes is the John Allan Love Professor of Law at the University of Virginia School of Law. For helpful comments, he thanks participants at the Consumer Credit in American symposium, held at Duke University School of Law as well as participants at the Ethics of Bankruptcy Roundtable, held at Georgetown University.

1. FED. TRADE COMM’N, REPORT TO CONGRESS UNDER SECTION 319 OF THE FAIR AND ACCURATE CREDIT TRANSACTIONS ACT OF 2003 iv (2012), <http://www.ftc.gov/sites/default/files/documents/reports/section-319-fair-and-accurate-credit-transactions-act-2003-fifth-interim-federaltrade-commission/130211factareport.pdf> [<https://perma.cc/UJ9S-Q7ZV>].

2. See CONSUMER FIN. PROT. BUREAU, KEY DIMENSIONS AND PROCESSES IN THE U.S. CREDIT REPORTING SYSTEM 5 (2012), [http://files.consumerfinance.gov/f/201212\\_cfpb\\_credit-reporting-white-paper.pdf](http://files.consumerfinance.gov/f/201212_cfpb_credit-reporting-white-paper.pdf) [<https://perma.cc/L9GS-6XEF>].

3. See *Safeco Ins. Co. of Am. v. Burr*, 551 U.S. 47, 53–54 (2007).

4. See CONSUMER FIN. PROT. BUREAU, *supra* note 2, at 2.

5. *Equal Emp’t Opportunity Comm’n v. Kaplan Higher Educ. Corp.*, 748 F.3d 749, 750 (6th Cir. 2014).

6. For a humorous criticism, see Last Week Tonight with John Oliver, *Credit Reports*, [https://www.youtube.com/watch?v=aRrDsbUdY\\_k](https://www.youtube.com/watch?v=aRrDsbUdY_k) [<https://perma.cc/W9M4-LL64>].

7. See HEATHER MORTON, NAT’L CONFERENCE OF STATE LEGISLATURES, USE OF CREDIT INFORMATION IN EMPLOYMENT 2015 LEGISLATION (2015), <http://www.ncsl.org/research/financial-services-and-commerce/use-of-credit-information-in-employment-2015-legislation.aspx> [<https://perma.cc/8YCB-LGTG>].

impose a national prohibition.<sup>8</sup> Additionally, legislation sponsored by Representative Maxine Waters would: (i) reduce the period during which negative information can appear on credit reports from seven to four years, (ii) prohibit credit bureaus from reporting defaults if the consumers settled for less than the outstanding balance, (iii) prohibit the reporting of negative information related to loans deemed predatory or abusive, and (iv) regulate the scoring models users apply to the reports.<sup>9</sup> These reforms would limit the content or use of credit reports. Other proposed reforms seek to reduce reporting error, either by imposing greater liability for mistakes<sup>10</sup> or by having the government determine the reporting process. For example, Senators Warren and Sanders have also co-sponsored legislation that would allow courts to issue injunctions under the Fair Credit Reporting Act (FCRA) and have the Consumer Financial Protection Bureau (CFPB) promulgate a rule “establishing the procedures that a consumer reporting agency must follow to assure maximum possible accuracy.”<sup>11</sup>

This article begins with a question neglected by the existing literature: why regulate credit reporting at all? Although the answer may seem obvious given the importance of credit reports and the number of mistakes, this article argues that efficiency justifications for regulation are dubious. More specifically, the credit reporting market is imperfect, but existing and proposed regulations are poorly designed to address these market failures. Distributional or equitable justifications for regulation are more compelling, but the distributional consequences of regulation are unpredictable.

Standard tort theory suggests that liability would force the industry to internalize the harm that its mistakes inflict upon consumers and thus take the optimal level of care.<sup>12</sup> However, the case for holding the industry liable for its mistakes is not as strong as it appears. The private harm suffered by consumers is much larger than the social harm of mistakes because mistakes provide offsetting benefits to those with truly poor credit.<sup>13</sup> Mistakes harm lower-risk consumers by forcing them to share terms, or pool, with higher-risk consumers, but pooling also improves the terms offered to higher-risk consumers.

This article claims that the social costs of mistakes are smaller than the harm suffered by subjects of mistaken reports, not that there are no social costs. But

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8. Ann-Gerard Flynn, *Senator Elizabeth Warren Introduces Legislation to Exclude Credit History from Job Applications*, MASSLIVE (Aug. 6, 2015), [http://www.masslive.com/news/index.ssf/2015/08/senator\\_warren\\_introduces.html](http://www.masslive.com/news/index.ssf/2015/08/senator_warren_introduces.html) [<https://perma.cc/B7YE-ACFE>]; *Senator Warren Introduces Legislation to Prohibit Employers From Requiring Credit Report Disclosure*, ELIZABETH WARREN: U.S. SEN. FOR MASS. (Aug. 5, 2015), [http://www.warren.senate.gov/?p=press\\_release&id=917](http://www.warren.senate.gov/?p=press_release&id=917) [<https://perma.cc/8VEB-2CYG>].

9. Comprehensive Consumer Credit Reporting Reform Act of 2016, H.R. 5282, 114th Cong. (2016).

10. See *infra* notes 42–43 and accompanying text.

11. Stop Errors in Credit Reporting and Use Act, S. 1847, 114th Cong. § 3(c) (2015).

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

13. For a discussion of offsetting benefits (but not credit reporting), see Ariel Porat & Eric Posner, *Offsetting Benefits*, 100 VA. L. REV. 1165 *passim* (2014).

would-be regulators must also explain why companies that use credit reports do not have sufficient incentives to demand accurate reports. The most plausible theories are that firms may spend too little on information because they will not recover these costs in a competitive market<sup>14</sup> and that firms may refuse to share information about consumers to reduce competition.<sup>15</sup>

Liability may exacerbate these market failures because the law holds the industry liable for misstatements but not omissions.<sup>16</sup> Instead of reducing misstatements, liability could cause the industry to refuse to report some information at all. But liability is not necessarily counter-productive because the FCRA imposes a negligence standard.<sup>17</sup> If courts set the correct standard and firms meet this standard, firms are not liable, and the law does not discourage reporting.

Firms use credit reports to sort consumers by risk, and society regulates the manner in which insurers<sup>18</sup> and creditors<sup>19</sup> can classify risks. Insurance scholars offer efficiency justifications for these laws,<sup>20</sup> but the most compelling justification (limiting classification expenditures)<sup>21</sup> does not justify laws that demand accuracy. Insurance scholars place greater emphasis on equity justifications.<sup>22</sup> These justifications are just as compelling in the credit-reporting context. For example, despite claims that old negative information is irrelevant,<sup>23</sup> research has shown that it predicts default.<sup>24</sup> However, much like bankruptcy provisions that discharge debts<sup>25</sup> and prohibit the government and employers from discriminating against bankrupt debtors,<sup>26</sup> the FCRA provision that prohibits the reporting of negative information can help unfortunate debtors.<sup>27</sup> Unfortunately, regulation may not always have the intended distributional consequences. One of the primary arguments for banning credit reports in

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14. See *infra* Part III.B.

15. See *infra* Part III.C.

16. See *infra* notes 137–139 and accompanying text.

17. See *infra* Part III.D.

18. See, e.g., Kenneth S. Abraham, *Efficiency and Fairness in Insurance Risk Classification*, 71 VA. L. REV. 403 *passim* (1985); Ronen Avraham et al., *Understanding Insurance Antidiscrimination Laws*, 87 S. CAL. L. REV. 195, 208–09 (2014).

19. See 15 U.S.C. § 1691(a) (2012) (prohibiting discrimination in credit markets).

20. See Avraham et al., *supra* note 18, at 204–14.

21. See *infra* notes 98–99 and accompanying text.

22. See Avraham et al., *supra* note 18, at 212–20.

23. See 114 Cong. Rec. 24,903 (1968) (“However, there is a further element here: that irrelevant and outdated information be discarded from the file.”).

24. See David K. Musto, *What Happens When Information Leaves a Market? Evidence from Postbankruptcy Consumers*, 77 J. BUS. 725, 746–47 (2004).

25. See, e.g., Richard M. Hynes, *Why (Consumer) Bankruptcy*, 56 ALA. L. REV. 121, 122 (2004).

26. 11 U.S.C. § 525 (2012).

27. Redistribution can sometimes improve efficiency. See *infra* notes 62–65 and accompanying text.

employment is that their use harms minorities,<sup>28</sup> but studies find that limiting the use of credit reports reduces minority employment.<sup>29</sup>

Even the FCRA accuracy provisions may be justified on distributional grounds. Ken Abraham argues that imperfect risk proxies cause “differential inaccuracy”<sup>30</sup> because misidentified consumers disproportionately bear the burden of subsidizing the truly high-risk. Mismeasured variables (faulty credit reports) are just imperfect proxies for the true variables (perfect credit reports),<sup>31</sup> and the differential inaccuracy argument extends to laws that sanction mistakes.

Congress did not define the term accuracy in the FCRA.<sup>32</sup> If the only goal were to maximize efficiency, the CFPB and the courts should interpret accuracy to mean predictive accuracy and defer to most industry choices; predictive accuracy means that a report allows users to better sort consumers by risk. Reducing misstatements does not always improve predictive accuracy; blank reports contain no misstatements but provide no help in predicting behavior. However, the FCRA calls for “fair and equitable” credit reporting,<sup>33</sup> and equitable goals may justify the current approach of scrutinizing misstatements more heavily than omissions.

Part II argues that the harms suffered by the subjects of mistaken reports almost certainly exceed the social costs of these mistakes because mistakes confer offsetting benefits on other consumers. In fact, mistakes can theoretically enhance efficiency. Part III argues that plausible market failures can lead to

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28. *Use of Credit Information Beyond Lending: Issues and Reform Proposals: Hearing Before the Subcomm. on Fin. Insts. & Consumer Credit of the H. Comm. on Fin. Servs.*, 111th Cong. 188–90 (2010) (statement of Chi Chi Wu, Nat’l Consumer Law Ctr.); Lea Shepard, *Toward a Stronger Financial History Anti-Discrimination Norm*, 53 B.C. L. REV. 1695, 1729–33 (2012); Amy Traub, *Discredited: How Employment Credit Checks Keep Qualified Workers Out of a Job*, DEMOS (Feb. 2013), <http://www.demos.org/discredited-how-employment-credit-checks-keep-qualified-workers-out-job> [<https://perma.cc/9QLM-JTAA>]; *Fact Sheet: Equal Employment for All Act* (Aug. 5, 2015), <http://www.warren.senate.gov/files/documents/FACT%20SHEET%20Equal%20Employment%20for%20All%20Act%20-%202013-12-16.pdf> [<https://perma.cc/K7Z4-F2HN>]; *NAACP Calls for Passage of Legislation to Ban the Use of Credit Scores as Determinant of Employment*, <https://donate.naACP.org/action-alerts/entry/naACP-calls-for-passage-of-legislation-to-ban-the-use-of-credit-scores-as--determinant-of-employment> [<https://perma.cc/XR8S-VDRB>] (last visited Mar. 12, 2017).

29. See Alexander W. Bartik & Scott T. Nelson, *Credit Reports as Résumés: The Incidence of Pre-Employment Credit Screening* 27 (MIT Dep’t of Econ. Graduate Student, Research Paper No. 16-01, 2016), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2759560](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2759560) [<https://perma.cc/AH4Y-P3UU>]; Robert Clifford & Daniel Shoag, “No More Credit Score” *Employment Credit Check Bans and Signal Substitution* 4 (Harvard Kennedy Sch. Faculty Research, Working Paper No. RWP16-008, 2016), <https://research.hks.harvard.edu/publications/workingpapers/citation.aspx?PubId=10941&type=WPN> [<https://perma.cc/6C45-EA2S>]. Friedberg, Hynes, and Pattison do not find a statistically significant effect on the unemployment duration of minorities, but this could be due to the limited number of minorities in their sample. See Leora Friedberg, Richard M. Hynes & Nathaniel Pattison, *Who Benefits from Credit Report Bans?* 1 (Dec. 19, 2016) (unpublished manuscript), [https://pattison-nate.github.io/FHP\\_CreditBans1219.pdf](https://pattison-nate.github.io/FHP_CreditBans1219.pdf) [<https://perma.cc/XV5V-WBZX>].

30. See Abraham, *supra* note 18, at 431–36.

31. See, e.g., WILLIAM H. GREENE, *ECONOMETRIC ANALYSIS* 221 (7th ed. 2012). A perfect report is itself a proxy for the actual variable: risk.

32. See 1 NAT’L CONSUMER LAW CTR., *FAIR CREDIT REPORTING* § 4.2.1.4 (8th ed. 2013).

33. 15 U.S.C. § 1681(b) (2012).

inaccuracy, and existing and proposed regulations are poorly designed to address these failures. Part IV argues that equitable justifications for regulation are more plausible. Part V concludes.

## II

### SOCIAL COSTS OF REPORTING ERRORS

Reporting errors are common and inflict serious harm. The FTC found a material error rate of twenty-one percent,<sup>34</sup> with material errors defined as items that changed after consumer investigation.<sup>35</sup> Restricting attention to errors that could affect the terms of automobile credit reduces the error rate to five percent.<sup>36</sup> Consumers spend time and treasure correcting errors,<sup>37</sup> and the literature recites stories of errors that led to the denial of employment, housing, insurance, or credit, or that caused the consumers to earn less or pay more.<sup>38</sup>

The reporting industry could reduce mistakes by changing its process. Creditors could take greater care to avoid data-entry errors and verify consumers' identities, and they could update account statuses more frequently. Credit bureaus could more carefully monitor creditors who furnish information and omit information unless it matches a file along multiple dimensions (full name, address, social security number, for example). All participants could spend more time and money investigating alleged mistakes; currently credit bureaus spend less than a dollar investigating each allegation.<sup>39</sup>

Liability provides an incentive to minimize mistakes, but the FCRA only holds the credit bureau liable for negligent or willful behavior,<sup>40</sup> and creditors face almost no liability for misstatements.<sup>41</sup> Some scholars propose greater

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34. See FED. TRADE COMM'N, *supra* note 1.

35. *Id.* at 17. Other estimates differ wildly. See also JON GOLINGER, NAT'L ASSOC. OF STATE PIRGS: MISTAKES DO HAPPEN: A LOOK AT ERRORS IN CONSUMER CREDIT REPORTS 4 (2004), [http://www.uspirg.org/sites/pirg/files/reports/Mistakes\\_Do\\_Happen\\_2004\\_USPIRG.pdf](http://www.uspirg.org/sites/pirg/files/reports/Mistakes_Do_Happen_2004_USPIRG.pdf) [<https://perma.cc/2DXU-BFQP>] (reporting that 25% of credit reports contained a “serious error” and that 79% of credit reports contained some error); MICHAEL A. TURNER ET AL., U.S. CONSUMER CREDIT REPORTS: MEASURING ACCURACY AND DISPUTE IMPACTS 50 (2011), [https://www.transunion.com/docs/rev/aboutTransunion/credit-studies/Efficacy\\_DQreport.pdf](https://www.transunion.com/docs/rev/aboutTransunion/credit-studies/Efficacy_DQreport.pdf) [<https://perma.cc/W8K9-BRMS>] (reporting an error rate of 0.5%).

36. FED. TRADE COMM'N, *supra* note 1, at 1.

37. See, e.g., Julia Cheney et al., *Consumer Use of Fraud Alerts and Credit Freezes: An Empirical Analysis* 5–7 (Fed. Reserve Bank of Phila. Discussion Paper No. 14-04, 2014), <http://www.philadelphiafed.org/consumer-credit-and-payments/payment-cards-center/publications/discussion-papers/2014/D-2014-IdentityTheft.pdf> [<https://perma.cc/75UP-W4N9>].

38. See, e.g., Jeff Govern, *The Jewel of Their Souls: Preventing Identity Theft Through Loss Allocation Rules*, 64 U. PITT. L. REV. 343, 345–49 (2003).

39. See 1 NAT'L CONSUMER LAW CTR., *supra* note 32, § 4.5.6.4.

40. 15 U.S.C. § 1681n (2012); *Id.* § 1681o.

41. Creditors are liable for failing to investigate misstatements. 15 U.S.C. § 1681s-2(c).

liability either through strict liability<sup>42</sup> or weakening the FCRA's preemption of state law.<sup>43</sup>

The basic case for more liability is based on tort doctrine—strict liability causes tortfeasors (the reporting industry) to adopt efficient precautions by forcing them to internalize the costs of their actions (misstatements).<sup>44</sup> Negligence can also cause tortfeasors to adopt efficient precautions,<sup>45</sup> but not if courts find a suboptimal level of care to be non-negligent. Moreover, efficient precautions rarely eliminate risk. Once tortfeasors take precautions, they are not liable for any harm caused by their actions, and they will engage in too much of the activity.<sup>46</sup> The analysis is more complicated if victims can take steps to avoid loss, but this may not apply in credit reporting. It therefore seems reasonable to argue that strict liability would cause the industry to adopt the optimal level of care and reporting.<sup>47</sup>

Tortfeasors are liable for the victim's harm, but the private harm to the victim of a reporting mistake almost certainly exceeds the social cost of the mistake because mistakes confer offsetting benefits on other consumers. In a simple model that ignores misallocation, adverse selection, moral hazard, and the availability of alternative screening devices, reporting mistakes have no social costs; mistakes merely transfer wealth from low-risk consumers to high-risk consumers.<sup>48</sup> In this way, mistakes resemble errors of omission created by existing and proposed limits on the content or use of credit reports or other laws that limit the ability of a lender or insurer to offer better terms to lower-risk consumers. In this simplified model, credit scores are like test scores in a class that grades on a curve. In curved classes, easier tests do not mean higher average grades and there are no bonus points. Anything that raises one student's grade must lower another's. Competitive markets will push users of credit reports to grade on a curve, and reforms that enhance one consumer's credit report and access to credit will tend to reduce access for others.

But the world is plagued by misallocation, adverse selection, moral hazard, and signaling costs. And misstatements probably do create social costs, but they can also provide benefits. Prior scholars have shown that limits on the content of credit reports can theoretically improve welfare by mitigating moral hazard,<sup>49</sup> and misstatements can improve welfare for precisely the same reason.

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42. See, e.g., Chris Jay Hoofnagle, *Internalizing Identity Theft*, 13 UCLA J.L. & TECH. 2, 29–34 (2009); Sovern, *supra* note 38, at 391.

43. See, e.g., Elizabeth D. De Armond, *A Dearth of Remedies*, 113 PENN STATE L. REV. 1, 49–52 (2008); Elizabeth D. De Armond, *Preventing Preemption: Finding Space for States to Regulate Consumers' Credit Reports*, 2016 BYU L. REV. 365, 402–03.

44. See COOTER & ULEN, *supra* note 12, at 204.

45. *Id.*

46. *Id.*

47. See, e.g., Sovern, *supra* note 38, at 373.

48. See Richard M. Hynes, *The Social Costs of Credit Reporting Errors*, 2 J.L. ECON. & POL'Y 329, 340–41 (2015).

49. See *infra* notes 59–69 and accompanying text.

### A. Distributive Effects Of Reporting Errors

Both mistakes and limits on credit reporting should impair risk-sorting, improving the terms offered to some higher-risk consumers and worsening the terms offered to some lower-risk consumers. Both could also create social costs due to misallocation, adverse selection, moral hazard, and the search for alternative screening mechanisms, but simplifying the analysis demonstrates that much of the loss suffered by one consumer is offset by the gains enjoyed by others, and vice versa.

Assume one hundred consumers each borrow \$100 in a competitive market and that \$100 in the future is worth the same as \$100 today.<sup>50</sup> Eighty consumers are considered low-risk and never default. Twenty consumers are high-risk and repay nothing twenty percent of the time. If lenders can sort by risk, low-risk consumers would promise just \$100 because this allows lenders to break even. High-risk consumers would promise \$125 but would pay \$100 on average ( $0.8 * \$125$ ). If the law prevented lenders from sorting, all consumers would promise \$104.16 with an average default rate of four percent ( $0.96 * \$104.16 = \$100$ ). Since there are twenty high-risk consumers and they repay eighty percent of the time, the law confers an aggregate benefit of \$333.33 on the high-risk consumers ( $20 * 0.8 * (\$125 - \$104.16)$ ). However, this is exactly offset by the aggregate loss of the eighty low-risk consumers ( $80 * (\$104.16 - \$100)$ ).

Laws that limit the information in credit reports should also make some high-risk consumers better off and low-risk consumers worse off. Assume all low-risk consumers have perfect credit histories and all high-risk consumers have poor histories so that credit reports perfectly distinguish consumers. However, the law prohibits the reporting of some negative information so that five high-risk consumers have perfect reports, though their actual histories are poor. If lenders demand a \$100 promise from those with perfect reports, they would lose money because a little more than one percent (1.2%) of these debtors will default; creditors must demand about \$101.19 to break even. The five high-risk consumers with perfect credit scores gain an aggregate of \$95.24 ( $5 * 8 * (\$125 - \$101.19)$ ), precisely the same amount as the aggregate loss of the eighty low-risk consumers ( $80 * (\$101.19 - \$100)$ ). The law does not affect the other high-risk consumers; lenders will continue to demand \$125 from them.

Reporting mistakes can also transfer wealth from low to high-risk consumers. Assume that all high-risk consumers have negative reports and nine of the eighty low-risk consumers have (false) negative reports. Consumers with perfect reports are now all low-risk and will therefore promise \$100. Lenders may initially demand \$125 from the consumers with negative reports, but competition should drive the price down to about \$116. The actual default rate for consumers with

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50. Government-owned entities own or insure the majority of mortgages issued in this country. See Fed. Reserve, Mortgage Debt Outstanding Chart (Dec. 2016), <https://www.federalreserve.gov/econresdata/releases/mortoutstand/current.htm> [<https://perma.cc/4ZPB-C3VD>]. If this insurance offers an effective subsidy and is tied to fixed credit scores, changing the number of errors could affect aggregate lending.

negative reports is about fourteen percent because nine of the twenty-nine members of this risk-pool never default. If consumers promised \$125, the average repayment would exceed \$107.75 and lenders would enter the market.

Each of the nine misidentified consumers pays \$16 more because of the mistake, but their aggregate loss of \$144 equals the high-risk consumers' gain.<sup>51</sup> Each high-risk consumer promises \$9 less and keeps the promise eighty percent of the time, so their expected aggregate gain from the mistake is \$144, ( $20 * \$9 * 0.8 = 5 * \$16$ ). Ignoring misallocation, adverse selection, moral hazard, and the costs of alternative screening and signaling mechanisms, reporting mistakes are no more damaging than a lottery operator misreading the number of a winning ticket, causing Alice to win instead of Alan.

### B. Why Credit Reporting Errors May Have Social Costs

A more realistic analysis suggests that credit-reporting errors probably do create social costs, but the same is true of laws that limit credit reporting. First, high-risk borrowers may be unwilling to promise the \$125 necessary for the loan described in II.A. If high-risk borrowers only borrow because of legal limits or reporting mistakes, there is misallocation because the cost of giving them a loan exceeds the value of the loan to the borrower.<sup>52</sup> Sometimes, misallocation is acceptable because of the social benefits of granting access to credit or insurance to high-risk consumers. To illustrate by analogy, consider the market for health insurance. Limits on health insurance classification allow consumers with pre-existing conditions to pay dramatically less than an amount that reflects their actual usage of healthcare resources,<sup>53</sup> but few argue that this causes these consumers to consume too much healthcare. However, credit-reporting mistakes, particularly those that allow high-risk consumers to take on more debt than they should, create a plausible risk of misallocation that hurts the borrowers. If approved for a larger loan than they can afford, they may face financial distress accompanied by severe psychological and health consequences.<sup>54</sup> Thus, approving inappropriate loans for a high-risk consumer is not always a positive for the individual or society; some borrowers may have been better off had they never incurred the loans.

Second, low-risk consumers may be less willing to incur a loan at a given price than high-risk consumers, because they repay more often. If credit reporting laws or mistakes cause low-risk consumers to leave the market, this results in adverse

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51. Distributional considerations are discussed in part IV.

52. For the high-risk debtors, a promise to repay \$125 has an expected value of \$100, the opportunity cost of the loan.

53. See, e.g., JEAN P. HALL, REALIZING HEALTH REFORM'S POTENTIAL: WHY A NATIONAL HIGH-RISK INSURANCE POOL IS NOT A WORKABLE ALTERNATIVE TO THE MARKETPLACE 4 (2014), [http://www.commonwealthfund.org/~media/files/publications/issue-brief/2014/dec/1792\\_hall\\_highrisk\\_pools.pdf](http://www.commonwealthfund.org/~media/files/publications/issue-brief/2014/dec/1792_hall_highrisk_pools.pdf) [<https://perma.cc/3LDD-GBLS>].

54. See, e.g., Abby Abrams, *How Student Loan Debt Hurts Your Health*, TIME (June 11, 2014), <http://time.com/2854384/student-loan-debt-health/> [<https://perma.cc/T5YF-HPVB>].



selection,<sup>55</sup> the same process that happens in health care insurance markets when insurance rates have increased to a threshold that healthy individuals refuse to pay. As a result, there is no off-setting benefit to high-risk consumers as the pool of consumers has on average deteriorated.

Third, lenders and low-risk consumers have a strong incentive to find alternative methods of identifying those who are low-risk when credit scores do not accurately predict repayment or default. Consumers can spend time and effort correcting mistakes; these costs can be especially high for victims of identity theft.<sup>56</sup> Other methods include varying the size of the loan or requiring collateral.<sup>57</sup>

Finally, mistakes and legal limits can exacerbate moral hazard. Debtors share the fruits of their labor with their creditors when they repay, but the law and practical realities prevent creditors from fully collecting when debtors suffer adverse events and default.<sup>58</sup> This reduces debtors' incentives to avoid adverse events, creating moral hazard. Limits on credit reporting can exacerbate this moral hazard by lessening the consequences of default as the debtor may continue to have access to credit. However, prior scholarship has shown that less informative credit histories can also reduce moral hazard and improve social welfare.

Vercammen presents a model in which asymmetric information mitigates moral hazard if low-risk debtors can reduce the risk of misclassification by working harder.<sup>59</sup> In this model, sufficiently long and accurate credit reports allow lenders to correctly identify the borrower's ability (low or high-risk) so that the outcome of the debtor's latest project does not materially affect the lenders' assessment.<sup>60</sup> By contrast, if credit reports are imperfect, the project's outcome does affect the borrower's reputation in credit reports, providing her with an additional incentive to work hard.<sup>61</sup>

Elul and Gottardi focus on the incentives of the high-risk borrowers.<sup>62</sup> Imperfect credit reports reduce the amount that defaulting debtors pay for future

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55. For a general discussion of adverse selection, see George A. Akerlof, *The Market for 'Lemons': Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970). For a discussion of adverse selection in credit markets, see Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV. 393, 393 (1981).

56. See, e.g., Cheney et al., *supra* note 37.

57. See, e.g., Hellmuth Milde & John G. Riley, *Signaling in Credit Markets*, 103 Q.J. ECON. 101 (1988); Kei Kawai & Ken Onishi, *Signaling in Online Credit Markets* (Aug. 2014) (unpublished manuscript).

58. Scholars have long debated whether less generous bankruptcy laws would allow creditors to recover more or whether bankrupt debtors simply cannot pay. See, e.g., Robert M. Lawless et al., *Did Bankruptcy Reform Fail? An Empirical Study of Consumer Debtors*, 82 AM. BANKR. L.J. 349 (2008); Teresa A. Sullivan et al., *Rejoinder: Limiting Access to Bankruptcy Discharge*, 1984 WIS. L. REV. 1087.

59. See, e.g., James A. Vercammen, *Credit Bureau Policy and Sustainable Reputation Effects in Credit Markets*, 62 ECONOMICA 461, 461 (1995).

60. See *id.* at 462.

61. See *id.*

62. Ronel Elul & Piero Gottardi, *Bankruptcy: Is it Enough to Forgive or Must We Also Forget?*, AM. ECON. J.: MICROECONOMICS, Nov. 2015, at 294, 296.

credit by allowing them to pool with other debtors. This pooling has two offsetting incentive effects. Pooling makes default less painful and thus reduces the incentive to avoid default.<sup>63</sup> However, the reduced payments allow debtors to keep more of their income, thus increasing their incentive to work hard after default.<sup>64</sup> Elul and Gottardi show that the second effect of post-default effort can theoretically outweigh the first effect and that some forgetting could improve social welfare.<sup>65</sup>

Vercammen, Elul, and Gottardi use their models to justify limits on credit reporting, but their arguments can be extended to show that misstatements can improve social welfare for precisely the same reasons. The key to their arguments is that some low-risk debtors pool with some high-risk debtors. In Vercammen's model, the risk of pooling causes low-risk debtors to exert extra effort to avoid this misclassification.<sup>66</sup> In Elul and Gottardi's model, pooling causes defaulting debtors to receive better terms that cause them to work harder. In both models the pooling occurs because of the omission of negative information in high-risk debtor files, but such pooling can also occur because some low-risk debtors have false negative information in their files. However, it is not necessary to extend these models because Moav and Neeman make this point more broadly. In their model of the effect of the precision of information on an agent's incentives, Moav and Neeman show that a test (like a credit report) that misclassifies some low-risk (high-quality) agents as high-risk (low-quality) can improve welfare.<sup>67</sup>

These arguments suggest that mistakes and limits on credit reporting *may* improve welfare; they do not suggest that they must improve welfare because they rely on strong assumptions. For example, Elul and Gottardi focus only on the incentives of high-risk debtors and assume that low-risk debtors do not need to exert effort to succeed. Relaxing this assumption weakens the case for limits on reporting because pooling unambiguously reduces the low-risk debtors' incentive to work.<sup>68</sup> Moreover, each paper acknowledges that, depending on the assumed parameters, limits on credit reporting can also decrease welfare.<sup>69</sup> The

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63. *Id.* at 313.

64. *Id.*

65. *Id.*

66. See Vercammen, *supra* note 59, at 462.

67. Omer Moav & Zvika Neeman, *The Quality of Information and Incentives for Effort*, 43 J. INDUS. ECON. 642, 642 (2010) ("Accordingly, both imprecise and very precise public information about the agent's performance may destroy its incentive to exert effort.").

68. See Elul & Gottardi, *supra* note 62, at 315.

69. See *id.* at 313–15; Vercammen, *supra* note 59, at 472–73. Elul and Gottardi cite another paper to suggest that some existing limits on reporting may increase borrowing and therefore improve welfare. However, the authors of the study that they cite are more cautious. Bos and Nakamura study the effects of a change in Swedish credit reporting that reduced the time during which adverse information remains in the file and found that aggregate lending increased after the change. Marieke Bos & Leonard Nakamura, *Should Defaults be Forgotten? Evidence from Variation in Removal of Negative Consumer Credit Information* 6 (Fed. Reserve Bank of Phila., Working Paper No. 14–21, 2014). As a result, Bos and Nakamura conclude that they are "unable to rule out that the additional access to credit in the new regime increased welfare." *Id.* at 25–26. Bos and Nakamura also do not rule out the possibility that something else (such as an increase in worldwide subprime lending) caused an increase in lending around 2003.

same is true of misstatements. Although mistakes can possibly improve aggregate welfare, many believe that, given the number of mistakes already in credit reports, additional mistakes likely reduce welfare.

### III

#### EFFICIENCY JUSTIFICATIONS FOR REGULATION

Credit reporting suffers from market failures that may lead to suboptimal accuracy. However, many of the existing and proposed regulations are not well designed to address these market failures.

##### A. Existing Theories Of Market Failure

Perhaps surprisingly, it is easier to find efficiency arguments supporting limits on the content or use of credit reports than it is to find arguments supporting the FCRA’s accuracy requirements. Part II.B discussed two variants of one argument—limiting relevant information (thereby increasing asymmetric information) can sometimes enhance efficiency by mitigating moral hazard.<sup>70</sup> A more common argument is that the limits merely restrict access to irrelevant information. The FCRA’s legislative history states that old negative information is irrelevant,<sup>71</sup> and those who support a ban on the use of credit reports in employment similarly claim that these reports cannot be used to predict employment outcomes.<sup>72</sup> It would be surprising if credit reports were literally irrelevant to creditors and employers’ assessment of applicants, particularly as the term is defined in evidence law.<sup>73</sup> That standard merely requires prediction, not causation,<sup>74</sup> and credit information can be used to predict all sorts of surprising outcomes. For example, scholars have found that firms run by more frugal CEOs who purchase fewer luxury goods are less likely to make fraudulent or erroneous disclosures.<sup>75</sup> Credit scores can also help predict whether someone will stay in a committed relationship.<sup>76</sup> Musto provides much more direct

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70. This argument is sensitive to strong assumptions. See *supra* notes 59–69 and accompanying text.

71. See 114 Cong. Rec. 24,903 (1968) (“However, there is a further element here: that irrelevant and outdated information be discarded from the file.”).

72. See, e.g., Comprehensive Consumer Credit Reporting Reform Act of 2016, H.R. 5282, 114th Cong. § 3(4)(C) (2012); Shepard, *supra* note 28, at 1711; *Credit History is Not a Job Qualification: Support Equal Employment for All Act*, ELIZABETH WARREN FOR SENATE (2016), <http://my.elizabethwarren.com/page/s/creditreportbill#.Vs4EeTYrIdl> [<https://perma.cc/P3PT-Y5V9>] (“...[R]esearch has shown that an individual’s credit rating has little or no correlation with his ability to succeed at work.”).

73. FED. R. EVID. 401 (defining evidence as relevant if “it has any tendency to make a fact more or less probable than it would be without the evidence”).

74. See *id.*

75. Robert H. Davidson et al., *Executives’ ‘Off-the-Job’ Behavior, Corporate Culture, and Financial Reporting Risk* 2–3 (Chi. Booth Research Paper No. 12–24, 2013), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2096226](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2096226) [<https://perma.cc/5HME-XP88>].

76. Jane Dokko et al., *Credit Scores and Committed Relationships* 21–22 (Fin. & Econ. Discussion Series, Paper No. 2015-081, 2015), <https://www.federalreserve.gov/econresdata/feds/2015/files/2015081pap.pdf> [<https://perma.cc/K2F2-MXYF>].

evidence, showing that the old information the FCRA currently excludes from credit reports can still be used to predict consumer default.<sup>77</sup>

The relevance of credit reports in employment is less clear,<sup>78</sup> but at least some evidence suggests that reports help predict employee behavior. One study found a correlation between negative credit history and “counter-productive work behavior.”<sup>79</sup> However, critics point out that the study defined counter-productive work behavior to include a failure to repay debts.<sup>80</sup> Thus, the study may merely validate the principle that people who have failed to pay past debts are more likely to fail to repay future debts.<sup>81</sup> A second study found positive correlations between credit scores, supervisor ratings, and a measure of conscientiousness, but also found a negative correlation with a measure of agreeableness.<sup>82</sup> A third study is sometimes characterized as demonstrating that there is no relationship between credit reports and employment outcomes,<sup>83</sup> but that is not what the study actually shows. The study compared employees with negative terminations against employees with non-negative terminations or who were still with the company.<sup>84</sup> Employees with negative terminations scored worse on all thirteen

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77. See Musto, *supra* note 24, at 25–26.

78. For a survey supportive of the idea that there is a link between credit reports and employment outcomes, see James D. Phillips & David D. Schein, *Utilizing Credit Reports for Employment Purposes: A Legal Bait and Switch Tactic*, 18 RICH. J.L. & PUB. INT. 133, 152–56 (2015). For a more skeptical summary, see Shepard, *supra* note 28, at 1711–18. In all of these studies, it is difficult to foresee whether information predicts an employee’s performance and some leading firms (including Google) even question whether such commonly used metrics as interviews and grades predict performance. Robby Soave, *Google Executive: GPA, Test Scores ‘Worthless’ for Hiring*, DAILY CALLER (June 20, 2013, 4:09 PM), <http://dailycaller.com/2013/06/20/google-executive-gpa-test-scores-worthless-for-hiring/> [https://perma.cc/XGX7-UKL4].

79. Edward S. Oppler et al., *The Relationship Between Financial History and Counterproductive Work Behavior*, 16 INT’L J. SELECTION & ASSESSMENT 416, 416 (2008).

80. Bob Lawless, *The Evidence of Pre-Employment Credit Checks*, CREDIT SLIPS (Jan. 2, 2014), <http://www.creditslips.org/creditslips/2014/01/the-evidence-on-pre-employment-credit-checks.html> [http://perma.cc/K6Z7-MMEU].

81. See *id.*

82. Jeremy B. Bernerth et al., *An Empirical Investigation of Dispositional Antecedents and Performance-Related Outcomes of Credit Scores*, 97 J. APPLIED PSYCHOL. 469, 469 (2012).

83. See, e.g., Comprehensive Consumer Credit Reporting Reform Act of 2016, H.R. 5282, 114th Cong. § 3(4)(C) (2016) (“A study entitled, ‘Do Job Applicant Credit Histories Predict Job Performance Appraisal Ratings or Termination Decisions?’ published in 2012 found that, although credit history might conceptually measure a person’s level of responsibility, ability to meet deadlines, dependability, or integrity, it does not, in practice, actually predict an employee’s performance or turnover . . . .”); Amy Traub, *Credit Reports and Employment: Findings from the 2012 National Survey on Credit Card Debt of Low- and Middle-Income Households*, 46 SUFFOLK U.L. REV. 983, 988 (2013) (“The study found no relationship between the various indicators of poor credit and either the performance ratings of active employees or whether the employee was terminated.”).

84. Laura Koppes Bryan & Jerry K. Palmer, *Do Job Applicant Credit Histories Predict Performance Appraisal Ratings or Termination Decisions?*, 15 PSYCHOLOGIST-MANAGER J., 106, 106 (2012). This study also compared employees on a measure of performance and found no statistically significant correlation between all but one of their credit variables and performance. Curiously, the number of times that an employee was thirty days late was positively correlated with the performance evaluation. *Id.* at 117.

credit dimensions considered.<sup>85</sup> However, the authors could only be ninety percent certain that a few of the differences were not due to chance.<sup>86</sup> The authors speculate that “chance is probably the best explanation” for the differences in the averages.<sup>87</sup> Maybe they are correct, but a failure to reject a null hypothesis (there is no relationship between credit reports and employment outcomes) with ninety percent certainty is very different than a confirmation of the null hypothesis, and it is at least as likely that the true differences are much larger than their estimates. Their small sample size limited the power of their tests; they studied just twenty-six employees with a negative termination.<sup>88</sup> Moreover, the employer supplied the credit information and likely used the information in its hiring decisions.<sup>89</sup> The employer would presumably demand other more positive attributes from prospective applicants with bad reports, biasing the predictive power of reports downward.

Even if credit reports are useful for predicting employee behavior, one can still argue that their prejudicial effect outweighs their probative value because users overestimate their importance. Large, sophisticated users like Citibank and Capital One test the predictive value of information,<sup>90</sup> but they undoubtedly make mistakes. However, to justify regulation, one must also believe that Congress (or the CFPB) can better assess risk. Whether one finds this plausible depends on one’s view of the relevant competence of government and market actors.

Not all users of credit reports are large and sophisticated. Small lenders, employers, and landlords may have neither the time nor the ability to test the predictive value of credit reports. Users may be able to purchase expertise in the form of predictive scores that summarize the credit reports,<sup>91</sup> but perhaps the government can identify variables that decisionmakers routinely overweight. However, competition can reduce the mistakes made by even small users. Users who place undue emphasis on credit reports will make worse decisions than their competitors. For instance, they will overestimate the likelihood that consumers with high scores will repay their loans and underestimate the likelihood that consumers with low scores will repay their loans. In a perfectly competitive market, these firms should fail, and the firms that remain should be those that

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85. *Id.* at 117.

86. Only a few of the coefficients in the authors’ regressions were statistically significant. *Id.*

87. *Id.* at 119.

88. *Id.* at 112–13.

89. *See id.* at 107.

90. *See, e.g.,* Alex Woodie, *How Credit Card Companies Are Evolving with Big Data*, DATANAMI, (May 3, 2016), <https://www.datanami.com/2016/05/03/credit-card-companies-evolving-big-data/> [<https://perma.cc/MCA5-LM9Z>].

91. *See* CONSUMER FIN. PROT. BUREAU, *supra* note 2, at 10–12.

use the correct model.<sup>92</sup> Imperfect competition obviously limits this argument by allowing some mistaken firms to survive.

The only market failure argument offered by the existing literature to justify accuracy requirements is usually expressed in a few sentences. The following text, buried in a footnote of the December 2012 FTC study of the error rate in credit reports, is typical of the literature:

Thus, the [credit bureaus] have incentives to provide accurate information to lenders so that credit is extended to the appropriate people at the appropriate rate. There may be some asymmetry to the incentives, however, as it is more costly to extend credit to a consumer who defaults than to miss an opportunity to extend credit to a low-risk consumer.<sup>93</sup>

Though often repeated,<sup>94</sup> this analysis is flawed. An errantly extended loan is not one that defaults with certainty but rather one with an expected loss from default (roughly the probability of default times the loss from default) that exceeds the expected profit. At the margin, these two values should be roughly the same. Moreover, if the lender captures the gains from trade, it will internalize all of the costs and benefits from more accurate reports. Lenders do not, of course, capture all of the gains from trade.

## B. Lessons From The Insurance Literature

The law regulates insurance risk-classification.<sup>95</sup> For example, some states prohibit automobile insurers from discriminating based on age, and every state prohibits insurers from discriminating based on race.<sup>96</sup> Because credit reports are just another risk-classification tool, the insurance literature can provide regulatory justifications.

The most plausible efficiency justification focuses on sorting costs. Risk-classification has purely distributional consequences if one ignores complicating factors.<sup>97</sup> Limiting risk-classification helps high-risk consumers and hurts low-risk consumers. However, if the law limits the amount insurers spend on risk-classification, insurers no longer have to recover these costs and the benefit enjoyed by the high-risk consumers may exceed the loss suffered by the low-risk consumers.<sup>98</sup>

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92. This argument is somewhat similar to Gary Becker's claim that competition can reduce the effects of animus-based discrimination by employers. See GARY BECKER, *THE ECONOMICS OF DISCRIMINATION* 35–39 (1957).

93. FED. TRADE COMM'N, *supra* note 1, at 5–6.

94. For similar statements, see Robert M. Hunt, *A Century of Credit Reporting in America* 18–19 (Fed. Reserve Bank of Phila., Working Paper No. 05-13, 2005) (“For lenders, the expected loss associated with a type I error (the principal lost) is likely to be higher than the expected loss from a type II error (forgone profits on a loan).”); Michael E. Staten & Fred H. Cate, *Does the Fair Credit Reporting Act Promote Accurate Credit Reporting?* 7 (Joint Ctr. for Hous. Studies, BABC Paper No. 04-14, 2004) (“On a marginal loan, creditors faced higher costs from providing credit to the ‘wrong’ person than from denying credit to the ‘right’ person.”).

95. See Avraham et al., *supra* note 18, at 232–66.

96. *Id.*

97. See *supra* Part II.

98. See, e.g., Avraham et al., *supra* note 18, at 208. Restrictions may even benefit the low-risk types

Even though this argument might justify some limits on the content or use of credit reports, modern advocates do not argue that their reforms will reduce the amount spent on credit reports.<sup>99</sup> Moreover, the argument is inapplicable to those provisions of the FCRA that are designed to increase accuracy. As a general matter, the FCRA allows risk-classification as long as the credit bureaus spend enough to ensure that the classification is reasonably accurate, and many proposed reforms are designed to induce the industry to spend still more to increase accuracy.

A second efficiency argument for regulation is that insurers may be reluctant to search for better risk-classification schemes if their competitors can easily copy them.<sup>100</sup> One can make analogous arguments in credit reporting. Indeed, the history of credit reports (or credit ratings) on firms provides an extreme example. Today the subject firms pay for their own ratings, but at one time investors paid.<sup>101</sup> Scholars speculate that the photocopier made the investor-pays model unsustainable because it made free-riding easier.<sup>102</sup> Investors still pay for consumer credit reports, but investors may not be able to recover the full value of their information investment. If multiple lenders purchase the same information and then compete against each other for the consumer’s business, they may bid down the price of the loan to a level that doesn’t allow them to recover the cost of the information; information expenses are sunk costs.<sup>103</sup> This may cause users to be less willing to pay for credit reports, and the lower revenue may cause firms that prepare the reports to spend too little to ensure their accuracy.

Insurance scholars also argue that the contract terms offered to some individuals may confer positive externalities on the rest of society.<sup>104</sup> Manipulating risk-classification may be more efficient means of subsidizing their contracts than using the tax and transfer system.<sup>105</sup> However, this is just an extension of an equitable or distributional argument, and is therefore addressed in part IV.<sup>106</sup>

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by reducing wasteful signaling. See Phillippe Aghion & Benjamin Hermalin, *Legal Restrictions on Private Contracts Can Enhance Efficiency*, 6 J.L. ECON. & ORG. 381, 381–82 (1990).

99. One of the justifications for FCRA’s prohibition on reporting old negative information was to save on computer storage capacity. See Elul & Gottardi, *supra* note 62, at 297.

100. See Avraham et al., *supra* note 18, at 211. Avraham and his co-authors point out that this is a dubious justification for prohibitions on some forms of risk-classification because the market may not plausibly shift to better mechanisms.

101. See Anil K. Kashyap & Natalia Kovrijnykh, *Who Should Pay for Credit Ratings and How?*, 29 REV. FIN. STUD. 420, 423–24 (2016).

102. *Id.* at 440.

103. Creditors may also free-ride on the initial creditor’s investigation by using its loan or loan-offer as a signal of credit-worthiness.

104. See Avraham et al., *supra* note 18, at 210.

105. *Id.* at 211. Avraham et al. raise yet another argument: that risk-classification may deter individuals from discovering facts about themselves. *Id.* at 209–10. However, this argument is not easily extended to credit reports.

106. See *infra* notes 196–202, and accompanying text.

### C. Competition And Credit Reporting

To understand another possible market failure, one must consider the sources of the information in credit reports. Some information comes from public records such as court judgments and bankruptcy filings, but most comes from creditors in the form of account histories.<sup>107</sup> The literature has struggled to explain why creditors share this information.<sup>108</sup> Creditors that keep their customers' histories secret can prevent competitors from identifying their best customers and can charge these customers a higher price. Credit bureaus mitigate this problem by denying reports to creditors who refuse to share.<sup>109</sup> However, this may not be enough to induce sharing. If creditors share information about consumers with many competitors, the creditors will bid down the price that they can charge until they earn no economic profit.<sup>110</sup>

The literature offers several explanations for information sharing. Regulatory or structural market power may limit competition and lenders may need information about new customers who move into their protected markets.<sup>111</sup> Information sharing may dampen competition to acquire new customers.<sup>112</sup> Committing to share information may induce borrowers to repay their debts.<sup>113</sup> Finally, consumers may refuse to borrow from lenders who do not share information.<sup>114</sup> Although there is no voluntary credit reporting in the United States, the threat of competition could discourage participation.

Just as competition can discourage sharing information, it can also discourage the sharing of accurate information; credit-report mistakes give existing lenders an informational advantage. Credit bureaus can combat the incentive to provide inaccurate information in the same way that they combat the incentive to share no information at all—by denying access to reports to those who provide information with a very high error rate. Credit bureaus regularly monitor the

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107. See CONSUMER FIN. PROT. BUREAU, *supra* note 2, at 8–9; 1 NAT'L CONSUMER LAW CTR., *supra* note 32, § 3.2.3.

108. See, e.g., Marco Pagano & Tullio Jappelli, *Information Sharing in Credit Markets*, 48 J. FIN. 1693 (1993).

109. See, e.g., *id.* at 1693 (“[L]enders who do not provide data are denied access to the bureau’s files.”).

110. See *id.* at 1712–13.

111. *Id.*

112. Jan Bouckaert & Hans Degryse, *Softening Competition by Inducing Switching in Credit Markets*, 52 J. INDUS. ECON. 27, 41–42 (2004); Thomas Gehrig & Rune Stenbacka, *Information Sharing and Lending Market Competition with Switching Costs and Poaching*, 51 EUR. ECON. REV. 77, 77 (2007).

113. A. Jorge Padilla & Marco Pagano, *Endogenous Communication Among Lenders and Entrepreneurial Incentives*, 10 REV. FIN. STUD. 205, 205 (1997); A. Jorge Padilla & Marco Pagano, *Sharing Default Information as a Borrower Discipline Device*, 44 EUR. ECON. REV. 1951, 1951 (2000).

114. Guofang Huang, *What Makes Insurance Companies Voluntarily Share Proprietary Customer Information* 4 (Nov. 3, 2011) (unpublished manuscript), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1805220](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1805220) [<https://perma.cc/AH5G-ZUFG>].



accuracy of the information supplied by their furnishers and can exclude furnishers who make frequent mistakes.<sup>115</sup> Once again, however, this may not be enough if competitive pressures exceed the countering effects.

#### D. Are Regulations Well-Designed For The Market Failures?

The market may not supply sufficiently accurate credit reports. First, free-riding may cause firms to underinvest in credit reporting.<sup>116</sup> Second, competition may cause firms to fail to report accurate information.<sup>117</sup> Nevertheless, identifying a market failure is not enough to justify regulation. The regulation must also improve welfare given the market failure. Unfortunately, many of the FCRA provisions designed to improve accuracy are too concerned with misstatements in the file and insufficiently concerned with information omitted from the file.

The FCRA considers credit bureaus to be “consumer reporting agencies”<sup>118</sup> and insists that they “follow reasonable procedures to assure maximum possible accuracy.”<sup>119</sup> A creditor who provides information is a “furnisher” and cannot report information if it “knows or has reasonable cause to believe that the information is inaccurate.”<sup>120</sup> “Users” must notify the consumer if they take an “adverse action” (a denial or offering materially worse terms)<sup>121</sup> because of information in the credit report.<sup>122</sup> This notice entitles the consumer to a free credit report;<sup>123</sup> consumers can get an additional free report each year.<sup>124</sup> If the consumer properly disputes information in her report, the credit bureau must “conduct a reasonable reinvestigation” which shall include notification of the relevant furnisher.<sup>125</sup> This notice triggers the furnisher’s own duty to reinvestigate.<sup>126</sup>

The FCRA allows administrative enforcement<sup>127</sup> and private causes of action. Negligent violations lead to actual damages and attorneys’ fees;<sup>128</sup> willful violations also lead to statutory and punitive damages.<sup>129</sup> Furnishers face less risk of liability than the credit bureaus. Consumers cannot sue furnishers for negligently reporting false information; furnishers are only liable for failing to

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115. See CONSUMER FIN. PROT. BUREAU, *supra* note 2, at 18–19

116. See *supra* Part III.B.

117. See *supra* Part III.C.

118. 15 U.S.C. § 1681a(f) (2012).

119. *Id.* § 1681e(b).

120. *Id.* § 1681s-2(a).

121. *Id.* § 1681a(k).

122. *Id.* § 1681m(a).

123. *Id.* § 1681j(b).

124. *Id.* § 1681j(a).

125. *Id.* § 1681i.

126. *Id.* § 1681s-2(b).

127. *Id.* § 1681s.

128. *Id.* § 1681o.

129. *Id.* § 1681n.

reinvestigate after a credit bureau notification.<sup>130</sup> The FCRA preempts most state law actions, but the scope of this preemption is unclear. One provision preempts actions “in the nature of defamation, invasion of privacy, or negligence” but provides an exception for “false information furnished with malice or willful intent to injure.”<sup>131</sup> A more recently added section preempts state laws regulating furnishers and does not contain an exception.<sup>132</sup> Courts disagree as to how best reconcile the sections. Some courts hold that the latter section preempts all state law actions.<sup>133</sup> Others hold that the latter provision does not apply to state common law actions or to conduct that occurs before the furnisher receives notice of a dispute from a consumer reporting agency.<sup>134</sup> Scholars have proposed reforms that would expose the industry to greater liability, either by weakening the preemption provisions<sup>135</sup> or by imposing strict liability.<sup>136</sup>

As a general rule, the law holds the industry liable for including false information in a file but not for omitting truthful information.<sup>137</sup> There is a limited exception to this rule. Just as the common law required disclosure to correct a prior statement made inaccurate by subsequent events,<sup>138</sup> the FCRA insists that furnishers update reported information.<sup>139</sup> But the general point remains. American law does not require furnishers to report information. Liability for misstatements but not omissions acts as a tax on reporting information that can chill furnishers from reporting, credit bureaus from collecting, and users from purchasing credit reports. This potential chilling effect is why the common law granted qualified immunity to the credit industry.<sup>140</sup>

This potential chilling effect may also explain why the FCRA uses a negligence standard instead of strict liability. Scholars complain that, in the standard economic analysis of tort law, once the tortfeasor takes the required precaution she risks no liability and may engage in too much of the activity.<sup>141</sup>

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130. *Id.* § 1681s-2(c).

131. *Id.* § 1681h(e).

132. *Id.* § 1681t.

133. For an extended discussion of this conflict, see 1 NAT'L CONSUMER LAW CTR., *supra* note 32, § 10.7.4.

134. *See id.*

135. *See De Armond, A Dearth of Remedies*, *supra* note 43, at 48–49.

136. *See* Hoofnagle, *supra* note 42, at 32–34; Sovern, *supra* note 38, at 391–94.

137. The industry is also unlikely to face liability for wrongfully including false information that raises the consumer's credit score as many consumers will just remain silent, and even if they report the mistake they will have no damages.

138. *See, e.g.,* E. ALLAN FARNSWORTH, *CONTRACTS* 239–41 (4th ed. 2004).

139. *See* 15 U.S.C. § 1681s-2(a)(2) (2012) (requiring that furnishers correct and update certain information); Farm Credit Administration, Informational Memorandum, Clarification to FCA Regulation §618.8320(B)(7) (Nov. 19, 2012) (2012 WL 5879749 (F.C.A.)) (“[A] CRA [credit reporting agency] may report delinquent accounts in consumer reports, but must accurately note later payments or other significant activity on the account.”). For a longer discussion of “technical accuracy,” see NAT'L CONSUMER LAW CTR., *supra* note 32, § 4.2.3.

140. *See* Virginia G. Mauer, *Common Law Defamation and the Fair Credit Reporting Act*, 72 GEO. L.J. 95, 100 (1983).

141. *See* COOTER & ULEN, *supra* note 12, at 204.

Consider, for example, a railroad whose trains emit sparks that can burn the farmer’s field. If the railroad is deemed not negligent because it installs spark arresters that reduce (but do not eliminate) the risk of fire, it will not consider the losses from the remaining fires when deciding how often to run its trains. By contrast, strict liability would cause the railroad to internalize all of its trains’ costs and to choose the optimal number of trains. In the credit-reporting context this is a feature, not a bug. As long as the credit bureaus and the furnishers behave reasonably, and courts do not make mistakes, the industry will face no liability and there will be no chilling effect.

Perhaps negligence is not the correct standard. If the social costs of credit reporting mistakes are very small or the industry internalizes them, there is no need for any liability. Under this view, the common law’s qualified immunity was the correct approach, and the only beneficial provisions of the Fair Credit Reporting Act are those that preempt state law. On the other hand, if one focuses on the costs that consumers incur to correct mistakes, one may believe that the social costs of credit reporting are substantial and that creditors do not internalize them. This may be particularly true in the identity theft context because consumers are highly likely to spend time and effort to correct the mistakes in their file. Strict liability then looks more plausible as a way to sidestep some of the other problems with a negligence standard (for example, the need to define reasonable care).<sup>142</sup>

Instead of calling for greater liability, some have advocated for more direct government control of credit reporting. For example, legislation co-sponsored by Senators Sanders and Warren and legislation sponsored by Representative Waters would allow courts to grant injunctive relief under the FCRA and have the CFPB promulgate a rule specifying which procedures the credit bureaus should adopt to ensure accuracy.<sup>143</sup> The efficiency of direct regulation depends on the wisdom of the regulators, and some proposals suggest that would-be regulators may fail to appreciate the importance of omitted information. Consider proposals for improving the matching of information in credit bureau files. Proposals would require that credit bureaus match information on more dimensions (first and last name, date of birth, social security number, among others),<sup>144</sup> reducing the risk that information could be wrongfully placed in a consumer’s file. However, these reforms would also increase another type of error—omitted information.

For example, assume that a Professor Richard Hynes defaults on an obligation to a hospital in Charlottesville, Virginia. Should this information be

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142. All efforts (including the production of accurate credit reports) can be socially costly if they merely change the distribution of wealth. These costs could be substantial if some consumers falsely allege that that negative marks in their file are due to mistakes and courts have difficulty determining which claims are valid.

143. Comprehensive Consumer Credit Reporting Reform Act of 2016, H.R. 5282, 114th Cong. (2016).

144. *Id.* For a summary of other proposed matching requirements, see Sovern, *supra* note 38, at 369–71.

included in my file? It is at least possible that obligation was incurred by the more famous Professor Richard Hynes, the biologist at the Massachusetts Institute of Technology,<sup>145</sup> during a visit to Charlottesville, and refusing to include this information will give the hospital an incentive to more effectively identify its patients. However, creditors will not always follow best practices, and they will often make mistakes. They may, for example, list my name incorrectly as Richard O. Hynes. Because of the risk of mistake, credit bureaus will often include information in a file as long as it matches the file in two of four identifiers: (i) name, (ii) social security number, (iii) date of birth, and (iv) consumer account number with a subscriber.<sup>146</sup> The bureaus could reduce the number of entries wrongly included in my file by requiring more matches, but doing so would wrongly exclude some information that should be in my file. The question is whether the credit bureaus have the right incentive to choose the matching algorithm. If the goal is predictive accuracy, it is not clear why they would choose a poor algorithm or why some think that the government would do a better job. As explained in part IV, however, the analysis changes if equitable goals are considered.

Consider next proposals for mandating credit reporting by some entities. In the United States credit reporting is voluntary, but many countries mandate information sharing.<sup>147</sup> Some have argued that subprime lenders<sup>148</sup> or utility companies<sup>149</sup> should report customer behavior. These reforms are controversial even among consumer advocates. For example, the National Consumer Law Center worries that the inclusion of utility records could hurt the credit reports of lower-income consumers because they are more likely to miss payments.<sup>150</sup> Note, however, that if other variables indicate which consumers are low-income, these reforms should not increase or reduce the perceived risk of lower-income consumers as a group because the creditors can already identify them as a separate risk-pool. Rather, these reforms are likely to improve the perceived risk of some lower-income consumers (those that pay their utility bills on time) and reduce the scores of others (those that fall behind). In other words, this information would likely improve the predictive power of credit reports.

An efficient credit reporting system does not increase predictive power at all costs. At some point the costs of additional information exceed the benefits of improved predictive power. Justifying mandatory reporting requires an

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145. The other Professor Hynes' information is available at <http://hynes-lab.mit.edu/> [<https://perma.cc/TN6J-MSCK>].

146. See Lynn M. LoPucki, *Human Identity Theory and the Identity Theft Problem*, 80 TEX. L. REV. 89, 97 (2001).

147. See Tullio Jappelli & Marco Pagano, *Information Sharing, Lending and Defaults: Cross-Country Evidence*, 26 J. BANKING & FIN. 2017, 2028 (2002).

148. See Richard R. W. Brooks, *Credit Past Due*, 106 COLUM. L. REV. 994, 1013 (2006).

149. Ann Carrns, *The Movement to Put Utility Payments on Credit Reports*, N.Y. TIMES: BUCKS (Oct. 9, 2012, 2:38 PM), [http://bucks.blogs.nytimes.com/2012/10/09/the-movement-to-put-utility-payments-on-credit-reports/?\\_r=0](http://bucks.blogs.nytimes.com/2012/10/09/the-movement-to-put-utility-payments-on-credit-reports/?_r=0) [<https://perma.cc/QWK9-MZLC>].

150. *Id.*

explanation for why the industry will not report voluntarily. Free-riding arguably prevents the industry from investing sufficiently in information. On the other hand, mandatory reporting could have perverse effects as the industry would have to recover the cost of collecting the information. This might lead to more expensive credit reports which might, in turn, lead to fewer reports used. The other efficiency justification for mandatory reporting is that competition may deter voluntary reporting. Perhaps this justification applies to the subprime market. Although these lenders typically share information with their direct competitors (they have their own version of credit reports),<sup>151</sup> they may be reluctant to report to the standard credit bureaus for fear of losing customers to mainstream lenders.<sup>152</sup> However, utility companies usually enjoy monopoly power;<sup>153</sup> they are not refusing to report because of a fear of losing customers.

#### IV

##### A DISTRIBUTIONAL JUSTIFICATION FOR REGULATION

Society often sacrifices efficiency for equity.<sup>154</sup> Consider the income tax. An omniscient government would impose a lump-sum tax (or transfer) that varied with each household’s ability to pay, usually assumed to mean potential earnings,<sup>155</sup> and the size of the tax could vary to fit any definition of equity. The tax would not vary with the household’s choices. Thus, there would be no distortion and no efficiency loss. Real governments are not omniscient and cannot measure a household’s potential earnings. They instead assess a tax that increases with a household’s actual (adjusted) earnings, thus distorting choices like that between labor and leisure.<sup>156</sup> Society accepts these distortions because they aid in the transfer wealth to lower-income households.<sup>157</sup>

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151. Consumer Fin. Prot. Bureau, *List of Consumer Reporting Companies* (Jan. 2016), [http://files.consumerfinance.gov/f/201207\\_cfpb\\_list\\_consumer-reporting-agencies.pdf](http://files.consumerfinance.gov/f/201207_cfpb_list_consumer-reporting-agencies.pdf) [<https://perma.cc/M56Q-9C43>].

152. Payday lenders frequently advertise that they do not check credit reports and keep their loans confidential. See Jim Hawkins, *Using Advertisements to Diagnose Behavioral Market Failure in the Payday Lending Market*, 51 WAKE FOREST L. REV. 57, 73 (2016). Customers may not want lenders to share information because even the act of borrowing from a payday lender may be seen as a negative signal by other lenders.

153. See, e.g., Mingjie Gan, Comment, *Municipal Boundaries: A Barrier Between Customers and Adequate, Uniform, and Affordable Utility Service*, 120 PENN ST. L. REV. 923, 923 (2016).

154. This article adopts a utilitarian conception of equity. For a discussion of the variants of the utilitarian models of equity as well as some alternatives, see generally James Konow, *Which is the Fairest One of All: A Positive Analysis of Justice*, 41 J. ECON. LITERATURE 1188 (2003).

155. Joseph E. Stiglitz, *Pareto Efficient and Optimal Taxation and the New Welfare Economics*, in 2 HANDBOOK OF PUBLIC ECONOMICS 991, 1014 (Alan J. Auerbach & Martin Feldstein eds., 1987) (reviewing the relevant literature on taxation). For a recent overview of the literature, see Emmanuel Saez, Joel Slemrod & Seth Giertz, *The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review*, 50 J. ECON. LITERATURE 3 *passim* (2012).

156. See, e.g., Stiglitz, *supra* note 155, at 991–93 (noting the effect of taxes on incentives and the trade-off between equity and efficiency).

157. See, e.g., Harold M. Hochman & James D. Rodgers, *Pareto Optimal Redistribution*, 59 AM. ECON. REV. 542, 543 (1969) (arguing that “some redistribution will make everyone better off”); Stiglitz, *supra* note 155, at 991–93.

By calling for “fair and equitable” credit reporting,<sup>158</sup> the FCRA invites distributional considerations. The insurance literature provides a sense of these considerations. First, insurance scholars argue that society does not want insurers to use inherently suspect classifications such as those based on race.<sup>159</sup> The desire to limit racial discrimination provides at least some of the motivation for the proposed prohibition on using credit reports in employment.<sup>160</sup> These calls are not merely academic; the EEOC has sued firms that use credit scores in employment screening, claiming that this practice has a disparate impact on minorities.<sup>161</sup> Additionally, eleven states have passed laws restricting their use in employment.<sup>162</sup>

Just as advocates have used racial justice arguments to call for the restriction of the use of credit scores in employment, scholars and advocates have used similar claims to call for restricting the use of testing, criminal background checks, and drug testing for employment purposes.<sup>163</sup> However, other scholars have pointed out that these restrictions can actually reduce minority employment even if employment tests, criminal background checks, and drug tests are biased against minorities.<sup>164</sup> This counter-intuitive argument suggests that the restrictions could cause the employers to rely more heavily on signals that are even more biased against minorities (interviews for example) or simply refuse to hire minority applicants because they assume that they would have failed the background check, employment test, or drug test.<sup>165</sup> These critiques are less powerful if the law effectively prevents employers from using the alternative

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158. 15 U.S.C. § 1681a (2012).

159. See Avraham et al., *supra* note 18, at 215.

160. See *supra* note 28 and accompanying text.

161. Kevin P. McGowan, *EEOC's Failure to Show Disparate Impact Dooms Credit Check Bias Case, Court Affirms*, BLOOMBERG BNA (Apr. 11, 2014), <http://www.bna.com/eeocs-failure-show-n17179889528/> [<https://perma.cc/LQN4-4P3H>].

162. See MORTON, *supra* note 7.

163. See, e.g., MICHELLE ALEXANDER, *THE NEW JIM CROW: MASS INCARCERATION IN THE AGE OF COLORBLINDNESS* (2010); DORIS MARIE PROVINE, *UNEQUAL UNDER LAW: RACE IN THE WAR ON DRUGS* (2007); BRUCE WESTERN, *PUNISHMENT AND INEQUALITY IN AMERICA* (2006); Michael Carlin & Ellen Frick, *Criminal Records, Collateral Consequences, and Employment: The FCRA and Title VII in Discrimination Against Persons with Criminal Records*, 12 SEATTLE J. FOR SOC. JUST. 109 (2013) (documenting the statutory scheme and impact of the use of criminal records in the hiring process as well as potential solutions to this problem); Kimani Paule-Emile, *Beyond Title VII: Rethinking Race, Ex-Offender Status, and Employment Discrimination in the Information Age*, 100 VA. L. REV. 893 (2014).

164. See David H. Autor & David Scarborough, *Does Job Testing Harm Minority Workers? Evidence from Retail Establishments*, 123 Q.J. ECON. 219, 222 (2008); Harr J. Holzer et al., *Perceived Criminality, Criminal Background Checks, and the Racial Hiring Practices of Employers*, 49 J.L. & ECON. 451, 452 (2006); Abigail Wozniak, *Discrimination and the Effects of Drug Testing on Black Employment*, 97 REV. ECON. STAT. 548, 548 (2015).

165. See Autor & Scarborough, *supra* note 164, at 222 (“So long as the information provided by job tests about minority applicants is not systematically more negative than firms’ beliefs derived from informal screens, job testing has the potential to raise productivity without a disparate impact on minority hiring.”); Holzer et al., *supra* note 164, at 452 (suggesting that “the net effect of criminal background checks on the hiring of [African Americans] is theoretically ambiguous”); Wozniak, *supra* note 164, at 548 (“Drug testing provides a means for nonusing blacks to prove their status to employers, even as the drug war linked blacks with drug use in the popular imagination.”).

signals or otherwise discriminating against minorities. Further, the actual effect of restrictions on the use of employment testing and criminal background checks is an empirical question.

The available evidence suggests that laws meant to help minority job applicants actually hurt them. Clifford and Schoag looked at changes in employment after states enact a limit on the use of credit reports.<sup>166</sup> They found that these laws tend to increase black unemployment.<sup>167</sup> Bartik and Nelson employed a similar strategy, finding that these laws increased the likelihood that blacks would lose their jobs and reduced the chance that they would find a new job.<sup>168</sup> Although these are just two working papers, the literature on related restrictions further supports the claim that restrictions on employment screening may not help and may actually harm minorities. For example, Autor and Scarborough found that job testing has no measurable impact on minority hiring.<sup>169</sup> Wozniak found that laws that encourage drug-testing increase black unemployment and decrease wages, and that laws that discourage drug-testing result in the substitution of white women for black men.<sup>170</sup> Holzer et al., found that firms that use criminal background checks are more likely to hire African American workers.<sup>171</sup> Further, Doleac and Hansen found that recently enacted “ban the box” statutes reduce minority employment.<sup>172</sup>

A second argument in favor of restricting risk-classification is that some individuals are high-risk for reasons beyond their control; thus society wants to spread the costs as a matter of social solidarity.<sup>173</sup> For example, society prohibits insurers from charging higher premiums to individuals with genetic diseases<sup>174</sup> because these individuals’ choices did not cause their disease. In other cases, higher risk is only partially due to an individual’s choices, and society may accept some moral hazard as the price of spreading the costs. For example, advocates of restrictions on the use of credit scores in employment argue that bad credit scores are often due to medical emergencies or other events that are not typically associated with moral hazard.<sup>175</sup> The current gag rule on the use of old credit

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166. See Clifford & Schoag, *supra* note 29, at 4.

167. See *id.* at 3–4.

168. See Bartik & Nelson, *supra* note 29, at 19–22.

169. See Autor & Scarborough, *supra* note 164, at 221.

170. See Wozniak, *supra* note 164, at 549 (finding that pro-drug-testing legislation increases black employment and wages and that “employers substitute white women for blacks in the absence of testing”).

171. Holzer et al., *supra* note 164, at 474 (finding that firms that used criminal background checks are more likely to hire African American workers).

172. Jennifer L. Doleac & Benjamin Hansen, *Does ‘Ban the Box’ Help or Hurt Low-Skilled Workers? Statistical Discrimination and Employment Outcomes When Criminal Histories are Hidden 2* (Nat’l Bureau Econ. Research, Working Paper No. 22469, 2016), <http://www.nber.org/papers/w22469> [<https://perma.cc/99TH-J9E2>].

173. See Avraham et al., *supra* note 18, at 214.

174. *Id.* at 198–99 (citing the Genetic Information Nondiscrimination Act of 2008, Pub. L. No. 110-233, 122 Stat. 881, 883, 888 (codified as amended at 29 U.S.C. § 1182(b) and 42 U.S.C. § 300gg-1(b))).

175. See, e.g., CHI CHI WU, NAT’L CONSUMER LAW CTR., SOLVING THE CREDIT CONUNDRUM: HELPING CONSUMERS’ CREDIT REPORTS IMPAIRED BY THE FORECLOSURE CRISIS AND GREAT

information may be justified on these grounds. Society has long offered a “fresh start” to bankrupt debtors, in part because they are viewed as “honest but unfortunate.”<sup>176</sup> The primary component of this fresh start is the discharge, but bankruptcy law also prohibits the government and employers from discriminating against bankrupt debtors because of their insolvency.<sup>177</sup> Limiting access to information about bankruptcy or other adverse events could further—and broaden—this policy goal.<sup>178</sup> The initial empirical evidence suggests that it does. Friedberg, Hynes, and Pattison estimate that unemployed individuals with troubled financial histories find employment more quickly in states that limit the use of credit reports in employment.<sup>179</sup> Clifford and Schoag found that individuals living in areas with low average credit scores have improved employment outcomes in these states.<sup>180</sup>

The two prior equity arguments do not justify the FCRA’s accuracy requirements, but an expansion of Ken Abraham’s “differential inaccuracy” argument might.<sup>181</sup> According to this argument, “the risk of inaccurate classification should be borne by the community of all insureds, rather than by a few who suffer the entire disadvantage of inaccuracy.”<sup>182</sup> Abraham offers an example in which young male drivers have higher average insurance claims because a small number of young males will drive drunk, and it is not

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RECESSION 2 (2013) (“[M]any of these foreclosures and other adverse mortgage events were not caused by bad decisions made by the borrowers, but both economic forces out of their control and fraud or abuse by servicers/lenders. . . . They are not bad or irresponsible people, but simply unlucky.”).

176. *Grogan v. Garner*, 498 U.S. 279, 286, 287 (1991) (quoting *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934)).

177. 11 U.S.C. § 525 (2012). Courts disagree as to whether this provision prohibits private employers from discriminating against bankrupt debtors in employment because the code omits some language found in the prohibition against discrimination by the government. While the government may not “*deny employment to*, terminate the employment of, or discriminate with respect to employment against” bankrupt debtors, § 525(a) (emphasis added), private employers may not “*terminate the employment of, or discriminate with respect to employment against*” bankrupt debtors, § 525(b). *See* 4 COLLIER ON BANKRUPTCY ¶ 525.04[2] (Alan N. Resnick & Henry J. Sommer eds., 16th ed.); *Leary v. Warnaco, Inc.*, 251 B.R. 656 (S.D.N.Y. 2000); *Fiorani v. CACI*, 192 B.R. 401 (E.D. Va. 1996); *Pastore v. Medford Sav. Bank*, 186 B.R. 553 (D. Mass. 1995).

178. As noted in part II.B., the fresh start’s redistribution can have efficiency implications.

179. Friedberg, Hynes & Pattison, *supra* note 29, at 4.

180. *See* Clifford & Schoag, *supra* note 29, at 13. One paper also finds that the removal of negative information from the files of Swedish pawnshop customers improves their employment outcomes. *See* Marieke Bos et al., *The Labor Market Effects of Credit Market Information* 16 (Nat’l Bureau Econ. Research, Working Paper No. 22436, 2016), <http://www.nber.org/papers/w22436> [<https://perma.cc/269D-NJF5>]. Studies that examine the removal of records of bankruptcy filings after seven to ten years find mixed effects. One study finds that the removal of the flag improves employment outcomes, Kyle Herkenhoff et al., *The Impact of Consumer Credit Access on Employment, Earnings and Entrepreneurship* 17 (Nat’l Bureau Econ. Research, Working Paper No. 22846, 2016), <http://www.nber.org/papers/w22846> [<https://perma.cc/N52R-AHBM>], and yet another study finds little or no effect. Will Dobbie et al., *Bad Credit, No Problem? Credit and Labor Market Consequences of Bad Credit* 25–26 (Nat’l Bureau Econ. Research, Working Paper No. 22711, 2016), <http://www.nber.org/papers/w22711> [<https://perma.cc/RJY9-D8QA>].

181. *See* Abraham, *supra* note 18, at 431. This is sometimes framed in terms of a lack of a causal link, but critics are usually referring to poor correlation. *See* Avraham et al., *supra* note 18, at 218–20.

182. Abraham, *supra* note 18, at 431.



economically feasible to identify drunk drivers in advance.<sup>183</sup> He posits that “[i]f all insureds were unaware of their own characteristics . . . enough of them would want protection against the risk of being in the group bearing the burden of inaccuracy.”<sup>184</sup>

Abraham states that differential inaccuracy is an application of Rawls’s difference principle,<sup>185</sup> but one does not need such extreme egalitarianism to justify risk-classification bans. According to Rawls’s difference principle, society should stand behind the veil of ignorance and maximize the welfare of the least well off.<sup>186</sup> However, Rawls did not invent the veil of ignorance.<sup>187</sup> Others have used it to reach different conceptions of equity, such as maximizing expected utility. For example, Harsanyi argued that because the marginal utility of consumption declines with wealth, a risk-averse individual standing behind a veil of ignorance would sacrifice some of the wealth of the most well-off in exchange for a smaller increase in the wealth of the least well-off.<sup>188</sup> Rawls’s difference principle can be thought of as an extreme example of risk-aversion in which the individual would reduce the wealth of everyone in society to that of the pauper if the wealth of the pauper could be increased by just one dollar.

If an individual’s welfare is assessed solely in terms of how much she has to pay for credit or insurance<sup>189</sup> and that risk-classification does not enhance efficiency, then either Rawls’s difference principle or Harsanyi’s expected utility principle would ban risk-classification regardless of whether it is accurate. Banning classification would allow the highest-risk (and least well-off) consumers to pool with as many individuals as possible and maximize their welfare. In fact, these principles suggest that mistakes can improve equity by allowing the highest-risk consumers to at least pool with those low-risk consumers who are misclassified. This preference for inaccurate systems would likely change once efficiency considerations are introduced, because more accurate classification systems are probably more efficient.<sup>190</sup>

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183. *Id.* at 432.

184. *Id.* at 434.

185. *See id.* at 431.

186. *See* JOHN RAWLS, A THEORY OF JUSTICE 12, 148–49 (1971).

187. *See, e.g.,* John C. Harsanyi, *Cardinal Utility in Welfare Economics and in the Theory of Risk-Taking*, 61 J. POL. ECON. 434, 434–35 (1953).

188. *Id.*; John C. Harsanyi, *Cardinal Welfare, Individualist Ethics, and Interpersonal Comparisons of Utility*, 63 J. POL. ECON. 309, 314–16 (1955).

189. This assumption is too simplistic because automobile insurance would likely be just a small component of the budget of even the highest-risk drivers. The assumption is a little more plausible in another context in which differential inaccuracy has been used, AIDS testing. *See* Judith A. Berman, Note, *AIDS Antibody Testing and Health Insurance Underwriting: A Paradigmatic Inquiry*, 49 OHIO ST. L.J. 1059, 1073–74 (1989) (examining the use of ELISA (enzyme-linked immunosorbent assay) testing to detect HIV, in spite of the test’s high rate of predictive inaccuracy, which disproportionately required individuals found positive by the test to bear the full burden of the entire class of HIV-positive patients).

190. *See* part II.B for contrary arguments.

Abraham states that equitable considerations cannot justify laws that demand more accurate classification systems.<sup>191</sup> Yet his differential accuracy principle might be extended to do just that. Rather than spreading the cost of inaccuracy by causing higher risk consumers to pool with more people, the law would mandate that the industry spend more on risk-classification to reduce inaccuracy and pass the cost onto more individuals.

Assume that 950 low-risk and 50 high-risk consumers each apply for a \$100 loan in a competitive market with no time-value of money. The high-risk consumers will default totally and the low-risk consumers repay in full with certainty but are unwilling to repay more than \$110. Lenders can use free, but shoddy, credit reports that identify the high-risk consumers but also misidentify ten percent of the low-risk consumers as high-risk. Using this test, lenders will correctly identify 855 consumers as low-risk and offer them a loan requiring a repayment of \$100. Lenders will perceive 145 consumers as high-risk (50 truly high-risk consumers and 95 misidentified low-risk consumers); because no low-risk consumer is willing to pay more than \$110, none of these consumers will borrow.<sup>192</sup>

Now assume that there is another test, say better credit reports that identify all consumers perfectly. If the goal is to raise aggregate social wealth, society should spend at least \$950 to administer this test (\$0.95 per application) as it would identify 95 consumers who would otherwise not get a loan and allow each to contract on terms that yield \$10 in social surplus. For reasons previously explained, the industry may not adopt the perfect test even if doing raises aggregate social wealth. For example, lenders will not be able to recover the amount that they spent on the test if this cost is sunk at the time that lenders compete for the consumer's business.<sup>193</sup> But distributional concerns suggest that consumers may prefer that lenders adopt the perfect test, even if the cost of the test exceeds \$950. Assume that the perfect test costs \$1,000, or \$1.00 per application and that lenders can recover this cost by charging an additional \$1.05 ( $\$1,000/950$ ) for each consumer who is shown to be low-risk and qualified for the loan. Switching from the rough test to the perfect test has reduced the consumer's expected surplus. The rough test gave her a ninety percent chance of a \$10 gain, or \$9 on average, while the perfect test gives her \$8.95 with certainty. But if risk-averse consumers were given the choice before they knew whether their file would be the one with the mistake, they may choose \$8.95 with certainty to a ninety percent chance of \$10 and a ten percent chance of receiving nothing. In other words, risk-averse consumers may prefer that the market spend additional

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191. Abraham, *supra* note 18, at 431 ("Any classification system can achieve only a certain level of accuracy. Even if that level has not yet been reached, inefficiency, not unfairness, is properly the focus of criticism.").

192. The average probability of repayment in the high-risk pool is  $(95/145)$ , and so the required repayment must be at least  $\$152.63$  ( $\$152.63 * (94/145) = \$100$ ).

193. See *supra* notes 100–103, and accompanying text. The cost would not be sunk if lenders charged an application fee.

amounts to avoid the differential inaccuracy that afflicts the unlucky few who would otherwise find significant errors in their credit files.

Just as it is possible that more accurate credit reports are less efficient, it is also possible that they are less equitable. The previous analysis assumed that the high-risk consumers did not get a loan before or after the change and so did not consider their welfare. Relaxing this assumption would make the equitable considerations more complicated, because more accurate tests would cause fewer low-risk consumers to pool with the high-risk consumers. Thus the high-risk consumers would be worse off. If one believes that the high-risk consumers are the least well off in society and would benefit from the loan (both propositions are debatable), this would weaken the equitable case for more accurate credit reports.

Differential inaccuracy may explain why the law places greater weight on misstatements than omissions. Although the FCRA may hold credit bureaus liable for falsely reporting that a debtor had filed for bankruptcy,<sup>194</sup> credit bureaus face no liability for failing to report that a debtor filed for bankruptcy or missed payments, and the FCRA even prohibits credit bureaus from correctly reporting that other consumers had filed for bankruptcy eleven years ago.<sup>195</sup> Both mistakes and omissions make it harder to determine the risk that a particular debtor will default and thus will cause some lower-risk debtors to pool with some higher-risk debtors. But the limits on the use or content of credit reports should operate in a manner that causes relatively few higher-risk debtors (those with adverse events far in the past) to pool with a relatively large number of lower-risk debtors. In contrast, misstatements will cause relatively few low-risk debtors (those unlucky enough to have misstatements in their file) to pool with a large pool of high-risk debtors. As a result, omissions spread the cost of subsidizing high-risk debtors across the entire population of low-risk debtors while mistakes concentrate this cost on the unlucky few.

Equitable justifications help explain FCRA’s limits on the use or content of credit reports and its greater emphasis on misstatements than omissions, but, like other equitable policy justifications, they are vulnerable to the argument that it is more efficient to use the tax-and-transfer system to redistribute wealth.<sup>196</sup> A long literature explores the use of the tax-and-transfer system to redistribute wealth from high to low-income households,<sup>197</sup> but tax systems also redistribute wealth along other dimensions. For example, federal law allows individuals to deduct large medical expenses from their taxable income and gives the blind a higher standard deduction.<sup>198</sup> Society could use the tax-and-transfer system to

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194. See *supra* notes 118–129 and accompanying text.

195. 15 U.S.C. § 1681c (2012).

196. LOUIS KAPLOW & STEVEN SHAVELL, *FAIRNESS VERSUS WELFARE* (2002).

197. See, e.g., Anthony B. Atkinson, *Income Maintenance and Social Insurance*, in 2 *HANDBOOK OF PUBLIC ECONOMICS*, *supra* note 155, at 779; Louis Kaplow, *Taxation*, in 1 *HANDBOOK OF LAW AND ECONOMICS* 647 (A. Mitchell Polinsky & Steven Shavell eds., 2007).

198. See INTERNAL REVENUE SERV., *TAX BENEFITS FOR DISABLED TAXPAYERS: IRS TAX TIP 2011-24* (Feb. 3, 2011), <http://www.irs.gov/uac/Tax-Benefits-for-Disabled-Taxpayers> [<https://perma.cc/>

transfer sums to those with rare diseases (in lieu of health-insurance pooling) or even those with poor credit.

A potential advantage of using the tax system is that it avoids “double distortion.”<sup>199</sup> Some insurance scholars argue that using risk-classification to redistribute wealth can avoid the distortion of the labor–leisure choice created by the tax system.<sup>200</sup> However, the tax system need not distort the choice between labor and leisure if we are willing to accept the same distributional consequences of a limit on risk-classification. The law could, for example, offer individuals with genetic diseases tax credits and finance this credit by assessing a fixed tax on all other taxpayers. But restrictions on risk-classification may create another distortion because they make insurance or credit less expensive for high-risk households and more expensive for low-risk households. This is distortionary if it causes high-risk households to consume more insurance or credit than they would have had they been given an equivalent wealth transfer and low-risk households to consume less.

This is not the appropriate forum for reviewing the extremely large literature critiquing the “double distortion” argument.<sup>201</sup> However, at least a couple of the counter-arguments are plausible in this context. First, society may want to distort the high-risk households’ choices because these choices create externalities for the rest of society. Society may be pleased that risk-pooling can distort the sick’s choice of healthcare if it is more concerned about the health of the sick than the overall happiness of the sick. Similarly, if society gave a tax credit to high-risk drivers, they may continue to drive without automobile insurance, so society may wish to instead subsidize their insurance by forcing risk-pooling. Finally, unemployment may confer negative externalities on society in terms of crime and social assistance costs, so society may wish to subsidize the employment of high-risk employees by forcing risk-pooling rather than simply providing cash transfers or tax credits.

Administrative costs provide a second reason to prefer redistribution through risk-classification. Logue and Avraham argue that the government must expend resources to enforce restrictions on risk-classification, but the amount may be considerably less than the resources needed to determine the size of the transfer to offer to disadvantaged households and to verify that households are indeed disadvantaged.<sup>202</sup>

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199. See KAPLOW & SHAVELL, *supra* note 196.

200. See, e.g., Avraham et al., *supra* note 18, at 211 (“Second, assuming the risk-classification restrictions target only traits that are beyond the insured’s control (such as race or gender or genes), they have an advantage over a redistributive income tax regime, which has the notorious effect of distorting individuals’ work/leisure decisions.”).

201. See, e.g., Chris William Sanchirico, *Deconstructing the New Efficiency Rationale*, 86 CORNELL L. REV. 1003, 1014 (2001).

202. See Kyle Logue & Ronen Avraham, *Redistributing Optimally: Of Tax Rules, Legal Rules, and Insurance*, 56 TAX L. REV. 157, 214 (2003).

## V CONCLUSION

Credit-reporting mistakes can severely limit a consumer’s ability to obtain employment, credit, insurance, and housing. However, the social costs of these errors are likely to be significantly lower than the loss suffered by the mistakes’ victims because credit reports are risk-classification tools. If these mistakes force consumers into higher-risk pools and cause them to pay more for credit and insurance, they should also reduce the amount that those rightly in these risk-pools must pay. This does not mean that the social costs are zero, and plausible market failures may prevent the industry from taking sufficient care to avoid mistakes. However, this article argues that the efficiency justifications for existing and proposed regulations are still dubious because the regulations are not designed to address these market failures and are instead likely to make them worse. Most significantly, the law holds the credit reporting industry liable for misstatements but not omissions. As a result, greater liability is likely to replace one type of error (mismeasured variables) with another (omitted variables).

Even though the existing and proposed regulations may reduce market efficiency, they may still be socially desirable if they can more effectively achieve socially preferred redistribution than can the tax-and-transfer system. This desire for equity, and in particular the desire to reduce differential inaccuracy, may explain the law’s disproportionate focus on misstatements over omissions as well as the desire to prohibit the use of some information.