Study of the Payday Loan Borrowers in Lithuania

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Abstract

Payday loans became popular very rapidly and recently, causing much controversy among general public and policymakers. The authors propose the framework of analysis and use data from extensive payday borrowers’ survey, conducted in Lithuania. Descriptive analysis of the findings is presented in order to explain the behavior of payday loan borrowers in Lithuania and suggest the right legislative response.

The results indicate that in general access to payday loans is useful for borrowers. Moreover, they have alternatives available which are not used mostly because of the shame to ask for help. Findings also suggest that most of borrowers struggle with repayments, although some rollovers are not affecting the general utility of services. The authors' findings suggest that restriction of access to credit might disproportionally harm ones in need. Accordingly, authors conclude that access to credit deserves special scrutiny and very careful regulation in order to avoid unreasonable and severe consequences of legislative error.

JEL classification codes: G28/D12/D14/D18

Keywords: payday lending, credit access, transaction, behavior, rollover

1. Introduction

The payday lending market has emerged and has been rising rapidly in Lithuania as the result of sudden increase of liquidity concerns and restricted access to the mainstream credit at the peak of overall economic hardship in 2008 – 2009. However, tremendous growth of service popularity had caused much controversy among general public and policymakers.

The mainstream view is that quick and easy payday loans are abusive and have negative impact on welfare of the fragile borrowers. Indeed, payday lending practices have earned a bad name because of public charges on immoral and irresponsible lending, decorated by the horror stories of loans-gone-wrong. As a response to such charges, the industry has tried to justify itself with high transaction costs and marginal utility of having the lender of last resort available to the consumer in high and sudden need. This tension between the need of access to credit and the greed of lenders has attracted attention of the scholars, who found many challenging fields for theoretical and empirical research. Yet, the payday lending phenomenon in Lithuania may be summarized as over-controversial and under-explored, causing over-reaction of the regulator.

1 Reference to “payday lending” is used by authors to indicate short term (up to 1 month), small amounts (up to 1000 LTL), high cost (up to 200% of total cost of credit) loans, without any reference to a specific procedure of lending. Use of the term is not intended to indicate specific practice of advance payment of persons paycheck – the specific process of lending services, common in USA.
Having it said, the purpose of this paper is to present the empirical evidence on the payday borrowers choices and its consequences, in order to understand what regulation is appropriate for payday lending market in order to create safe and transparent marketplace.

The methodological design of the study is based on the data from extensive payday loan borrowers’ survey, conducted in Lithuania on 2013-2014. Descriptive analysis of the findings is presented in order to explain the behavior of payday loan borrowers in Lithuania.

Findings of the study indicate that most of payday loan borrowers, on average, are medium age with medium level of income. Borrowers use this type of credit to smooth financial shocks in emergency situations and to cover the most basic needs at the times when subjectively none of the alternatives are accessible to that borrower. Thus restrictions on access to credit may disproportionately harm most of consumers. However, the results revealed that objectively some of the alternatives are accessible to the borrowers and some of them are over-confident with their ability to repay. Most payday loan borrowers struggle with repayment. All of these findings seems to justify the legal intervention into the market. The policy issue, as we conclude, is: what is the right regulation?

Practical implications, as our findings suggest, most of the payday borrowers treats the overall service as useful lender of the last resort, however they struggle with repayments. Accordingly, we conclude that the access to credit deserves special scrutiny and very careful regulation in order to avoid unreasonable and severe consequences of legislative error. Having it said, we offer the new conceptual approach to the research of the right regulation of payday lending practices for further scientific and practical elaboration.

The value of this paper lies in the contribution to the study of payday lending market in Lithuania and research of appropriate policy response. However, the knowledge, wisdom and understanding of fair balance between the need of borrowers and the greed of lenders are way too far from being complete. Major legal, economic and organizational challenges are left for further theoretical treatment and empirical proving.

The structure of the paper has been divided into four sections. First of all, the background of the study will be presented, then we will proceed with the conceptual framework and methodological aspects of the study, overview of the payday lending market in Lithuania and we will finish with the discussion of borrowers use of payday loans in Lithuania. The conclusions will follow.

2. Background of the study

It is a Nobel Peace Prize honored fact that welfare may be increased directly through greater access to credit (Yunus, 2006). It is also generally acknowledged that consumer credit has become a common source of finance for households (Betti et al., 2007). Therefore being indebted is commonly treated as a normal consumer behavior, inevitable for the majority of households (European Commission, 2001, 2008, 2010). The importance of credit on the household welfare had even triggered the discussion whether access to credit should be considered as the Human Right *per se* (Hudon, 2009). Thus credit is inevitable part of welfare discourse.

This discourse, however, is not new at all. With the special emphasis on the usury and other aspects of credit relations, the moral dilemma of lending for a charge has evolved throughout millennia, starting from the Code of Hammurabi (~1750 B.C.), teachings of all major religions and writings of history’s greatest thinkers² (Bodenhorn, 2005; Rutherford, 2005; Temin and Voth, 2004; etc.). Despite the great history and extensiveness of credit

² Aristotle, Aquinas, Locke, Smith, Bentham, Keynes and many other academic superstars are just a few to mention.
studies, evolving markets and financial innovations keep bringing the scholars at the table to review these theories over and over.

One of such recent financial innovation became the “alternative” or “fringe” lending services, such as payday, auto-title, pawnshop, refund anticipation, and rent-to-own loans (McKernan, Ratcliffe, Kuehn 2013), designed to serve the poor households (Marston Shevellar, 2013; Elliehausen and Lawrence, 2001). Started in 1990-ies, in 2008 fringe lending became a 44 billion USD market, with more shops than McDonald’s and Starbucks combined (Dobbie ir Skiba, 2012). The services of small amount, short term, high cost lending has also spread considerably in UK, Australia (Marston and Shevellar, 2013), and other parts of the world, including Lithuania, attracting much of the attention from media, legislators and scholars. The scientific discussion generally stems from disagreement on whether payday loans benefits or harms borrowers (Skiba, 2012, Cuffe, 2012; Bhutta et al., 2012; etc.).

Indeed, there is a clear scientific evidence supporting the existence of a liquidity constraint, severer and more widespread over-indebtedness, where consumers have less access to credit market (Betti et al., 2007). It is argued that payday loans are used as a credit of last resort, helping borrowers smooth negative shocks, better manage liquidity and alleviate financial distress (Morse, 2011; Wilson et al., 2010; Morgan and Strain, 2008; Elliehausen, 2009; Edmiston, 2011; Caskey, 2002, 2010; and others). It is proved that payday loans are used when cheaper alternatives are unavailable (Bhatta et al., 2012), or exhausted (Dobbie ir Skiba, 2012), and therefore restricting access to expensive credit harms consumers on average (Zinman, 2010). Moreover, the researches of the links between access to payday credit and defaults, small crimes and other negative social events has revealed that restrictions of payday credit access actually increase the rate of defaults and property crimes (Morgan and Strain, 2008, Morse, 2011, etc.). Restrictions of the access to payday loans might be harmful to the creditworthiness of the borrower and might force him to search for more expensive or shadow alternatives (Mann and Hawkins, 2007; Edmiston, 2011). Even institutional investigations reveals that limiting access to credit may make some people considerably worse off (European Commission, 2001); that problems of managing debt, and of covering the costs of servicing loans, are likely to increase rather than diminish if there is a cutback in credit (European Commission, 2010).

On the other hand, the receipt of credit implies the duty to repay the principal and usury (interest). Obviously, profit seeking lender will be willing to lend only if the interest overweight the risks of the transactions. It means that the poorer the household is, the higher price of credit he will get. Further, the higher the price of credit is, the higher is the risk of default and hence the result will be harsh repayment process, which is directly linked with the threat of opportunism, over-indebtedness, debt-cycling, rollovers and other events that exacerbates financial distress (Bhatta et al., 2012; Carrell and Zinman, 2008; Melzer, 2009; Zinman, 2010, and others).

Moreover, it is generally accepted fact that people suffers from imperfect rationality, impatience, over-optimism, over-confidence and other behavioral anomalies (Fritzdixon et al., 2013; Kahneman ir Tversky, 1974; Simon, 1995). Since individuals “often make serious mistakes in deciding important matters” (Epstein, 2006), facing the choice to increase the consumption capacity (receive certain benefits today) and to pay later (bear the costs in uncertain future), some of the population will inevitably err. The major problems, of course, lies not in the natural human nature to err. Rather it is in some of the lenders’ strategic response to these errors.

Some lenders knowingly exploit these behavioral anomalies or the borrowers’ dire need of funds. The excessive profiting from current needs, disregarding the future consequences of over-indebtedness, might harm household more than under-consumption or financial exclusion. Therefore payday industry has been accused of exploiting the weaknesses
of consumers’ cognitive abilities and financial illiteracy (Gill and Warren, 2008). Skiba and Tobacman (2011) have proved the link between accessibility of payday loans and personal bankruptcy. Moreover, it has been proved that better information reduces the use of payday loans, which generally allows concluding, that some of the borrowers act irrationally (Bertrand and Morse, 2011). It is also revealed that frequently payday borrowers asks for loan repetitively, meaning that payday borrowers does not save for unexpected events and uses a payday loans to cover regular expenses (Bhatta et al., 2012; Skiba and Tobacman, 2008; PEW, 2012). Critics to refer to payday lending as the credit market’s equivalent of crack cocaine: a highly addictive source of easy money that hooks the unwary consumer into a cycle of debt (Stegman, 2007). Accordingly, the paternalistic intervention restricting access to credit may indeed prevent household from harmful error of choice.

However, the regulative issue at stake, as correctly pointed by Bar-Gill (2007), “is not whether individuals make mistakes. Sure they do. The question is whether these mistakes merit legal intervention“. That is, does the government really a priori knows better what is best for me, or should I be left with a chance to decide by myself? Any, especially fragile, borrower may be a loan-short of finding the solution for indignity threat. Access to whatever expense credit might be the last chance to buffer the impacts of financial shocks and stabilize the financial capacity of a household. The error in preemptive restriction of access to credit may be as harmful as over-indebtedness: shadow borrowing, opportunistic activities, crimes, divorces and depression with its extreme suicidal form are just few to mention. Therefore paternalistic restrictions of access to credit might disproportionately harm those, who would have acted rationally. Thus, access to credit deserves special scrutiny and very careful regulation in order to avoid unreasonable and severe consequences of legislative error.

It is generally acknowledged in this field of studies, that considering regulation of payday lending services, one has to study at the behavioral patterns of the borrower and analyze why he chooses this kind of loan and what are the consequences of such choice (Fritzdixon et al., 2013). The development of behavioral law and economic throughout past four decades has had a big impact on the regulation of consumer credit. Irrationality of behavior and mistakes of choices here is seen as an object of study and regulation (Write and Stone, 2012). Accordingly, the legislative policies aims to maintain or increase freedom of choice and takes the best interest of the person making the choice as the aim of the legislative design, attempting to move people in directions that will make their lives better (Thaler and Sunstein 2003, Thaler et al., 2010).

However, this study is not intended to elaborate on regulation issues any deeper. It will be done elsewhere. The aim of this paper is to look at the characteristics and behavior of payday borrowers in Lithuania, in order to set a background for modeling the regulatory response to the errors of choices (if any). Having it said, we turn to the discussion of the conceptual framework and methodological setting of current study.

3. Conceptual Framework and Methodological Aspects of the Study

3.1. Enhanced Kamleitner - Kirchler model

The foundational principle and kind of framing constraint of this study relies primarily on the ideas of methodological individualism, i.e. the assumption that individuals are the only agents of human action. Hence the ultimate unit of analysis is individual credit transaction and the decisions of self-governing borrower.

Any transaction, we believe, starts from the intent (will) for an action, continues with an action itself and ends with the result of an intended action. Intent of an actor, whether clearly perceived or intuitive, may be seen as a current state of individual, which is intended
to be modified by some chosen action. These intentions may be driven either by needs or wants of the individual. After realization of an action, the prior (ex-ante) state of individual becomes modified (ex-post) state of individual, which in turn may lead to new actions and so on. Thus the atom of transaction may be visualized as following:

**Figure 1.** The atom of transaction

![Diagram of the atom of transaction](attachment:atom_of_transaction.png)

It should be noted in this regard, that intent is always a future oriented and future suffers from uncertainty. Therefore any choice of action is always susceptible to an error. The outcome of an action may not be as intended, thus leaving individual with the same needs (or wants) plus the costs of an action and the consequences hereof, which may serve as a bridge to a chain reaction of new needs (or wants) to correct the mistake of choice. On the other hand, mistake may be welfare enhancing too. Unintended results of an action may be better than ones originally intended.

Having it said, the conceptual framework of payday use in this paper stems mostly from the model of credit use, elaborated by Kamleitner and Kirchler (2007). In the seminal paper *Consumer credit use: a process model and literature review* these scholars had provided a conceptual process model of consumer credit use from the perspective of the borrower. Although the approach is very correct, Kamleitner - Kirchler model does not capture some of the behavior scenarios and is susceptible for simplification. Using the set of individual transactions, briefly described above, the Kamleitner - Kirchler model may be updated as follows:

**Figure 2.** Conceptual process model of credit use

![Diagram of the conceptual process model of credit use](attachment:conceptual_process_model.png)

*Source: Adapted from Kamleitner and Kirchler (2007)*

Vertical brackets split the model into three major parts of the credit process, same as in Kamleitner - Kirchler model: (i) Process before credit take up; (ii) process at credit take up; (iii) process after credit take up. The model also acknowledges that human behavior in all steps of the model is influenced by interacting situational and personal characteristics.

The differences that should (may) be done to this model, lies in the logics of the transactions within the three stages. Process should have its start and end. Any “dead-ends”,
“closed-loops” are generally considered to be an errors of the process. Moreover, layering all process in the logics of transactional atom, the state shall lead to action, which in turn should lead to another state and so on. There shall not be state-to-state or action-to-action connections. Having it said, we follow with the brief description of all three stages of the payday credit use process.

**Part I: processes before credit take up.** First transaction (1) assumes, that any use of credit starts from desire for certain good. The desires originate from needs (or wants) for effects (e.g. if one needs to get warm, the desire for clothes originate). The needs for effects, as correctly pointed in Kamleitner – Kirchler model, originate from the market information in the broad sense. In our opinion, however, owns socialization, lifestyle, advertisements and other variables described by Kamleitner – Kirchler (2007) should be included in situational and personal characteristics and thus should not be shown as independent ones. Moreover, since the need lead to desire and there is no desire without a need, these two elements may be holistically seen as one element – desire for good that satisfies the needs. Hence the end goal of all process is the state of satisfied need. Accordingly, the transaction should be seen as effective, if the needs satisfied increase the welfare of an actor.

Depending of needs, the goods desired indeed may be classified into habitual, spontaneous or extensive decision purchases, as has been done by Kamleitner – Kirchler (2007). However the extensive decision process may be involved in habitual purchases too. For example starving poor may be exercising extensive decision for habitual purchase of food every single day. Thus the classification offered by Kamleitner – Kirchler (2007) is not precise. We ought to think that all desires may be classified into two groups – ones that are rejected and ones that proceeds towards the financing decision. Accordingly, individual here is making a first choice (spontaneous, habitual or extensive) between rejecting or proceeding with the purchase. The depth of analysis made, alternatives evaluated and other issues are encompassed in the process of this choice.

Individual may err in choosing or may have no choice available for certain goods. Latter are the goods that are needed in order to guarantee the well-recognized basic human right to “an adequate standard of living for himself and his family” (Article 11 of ICESCR\(^3\)), which encompasses food, shelter, healthcare, education, continuous improvement of living conditions and alike. For example refusal to eat leads to the fatal outcome, therefore in terms of our process, that person should not make decision to reject the need to eat.

Whether erroneous, or not, the choice leads either to the end of process or, to the need of own or borrowed funds. I.e. either individual satisfies his desires by rejecting his needs, or individual is facing the secondary need – money or other exchange intermediaries. Hence, the second part of the process starts.

**Part II: process at credit take up.** The second transaction has two groups of alternatives - (2) for the transaction of borrowing, and (3) for the transaction of using own funds. Of course, funding decision may be mixed, using some of the savings and some credit for the purchase. However, grouping funds into own and borrowed is common in finance and is well acknowledged by Kamleitner – Kirchler (2007). However, their model stops without deeper elaboration of these alternatives and this is the stage susceptible for expansion.

For the purposes of research of payday credit use, the subset of actions for credit (2) may be divided into the strings of mainstream (bank, credit union) and third-tier (payday, pawn, car-title, etc.) credit products. The subset of own funds (3) – into the strings of legal (savings, wages, sales of property, etc.) and illegal (theft, prostitution, default on obligations, etc.) sources. Any funding choice generally may be assigned to one of these groups.

The choice of financing source is determined by many various factors that will not be analyzed in depth here. It should be mentioned, however, that restriction of access to credit

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\(^3\) International Covenant on Economic, Social and Cultural rights (ICESCR)
may leave individual without any choice but to use own funds or jump back and reconsider his desires. If, at this point, individual does not have any legal sources accessible and he cannot reject his needs, the only choice that may be left is to break the law. Thus limiting access to credit may make some people outlaws.

Choice of financial structure is also susceptible for an error. This is where mandatory disclosures, responsible lending rules, price caps and other means of institutional design are meant to shape and rationalize the decisions of an individual. Although issues of regulation are not in the scope of current study, the obvious need of legislative attention at this stage leads us to assume that the libertarian paternalism (Thaler and Sunstein 2003, Thaler et al., 2010) is the prime regulative response to errors of individual.

Any action taken at this stage ends with the state of debt: either to mainstream or other credit institutions; to the individual himself (e.g. need to restore savings or property sold); or, in case of illegal actions and defaults - to the society or creditors. Hence, the third part of the process starts – repayment of debt.

**Part III: process after credit take up.** The final transaction has three groups of alternative actions – rejection (4), repayment (5), or refinancing (6) of the debt. Kamleitner – Kirchler model does not elaborate this stage at all, linking it to the very first step of the process – the need stage. Although this is generally correct, since the same behavioral scripts may be drawn from the choices in I and II stage of the process. However we ought to think, that desire for good (as an ex-ante need) and resulting debt (as a ex-post need) are different in kind and thus it is worth to investigate them separately. Hence the Kamleitner – Kirchler model of process after credit take up may also be expanded and explained.

The rejection of the debt (4) includes all and any legal actions that results in the relief of obligations to creditors (e.g. bankruptcy), to society (e.g. served punishment), or to the individual himself (e.g. decision not to restore savings). The rejection of the debt by illegal actions (e.g. default) should be classified as the refinancing (6) rather than rejection of the debt. The background of such classification is the basic principle of justice and inevitable responsibility for illegal actions. Illegal refusal to repay the debt cannot be a legal bridge to the end of process. The need of justice and public interest thereof shall guarantee that illegal acts would not create legal consequences relieving from debts. Hence illegal refusal to repay the debt is closer to the script of refinancing (which loops the need to repay the debt with the first step in the process) rather than to rejection (which results in satisfaction of needs).

Repayment (5) script includes repayments of debt only from the own property. Any follow-up credit to repay the credit is an action of refinance (6). Of course, individual may be using the same savings or property he had from the very beginning. If making decisions in I or II stage that individual had decided to use credit instead of savings (due to mental accounting bias, expectations of income, or other), facing the need to repay the credit at the end of term he may decide to review saving strategy and use still untouched property instead of refinancing. The difference between ex-ante use of savings and ex-post use of savings, in the context of credit, lies in the rate of interest. Whether that amount was worth delaying use of saving, or not, is a matter of subjective evaluation of the person himself.

Refinancing (6), whether rollover or repayment of debt by new credit, loops the need to repay the debt with the desire for certain good or service), which may be used in repayment. Although the process starts from the very beginning, the starting positions are completely different. First round has started with the choice, linked with the welfare of individual himself⁴. Second one starts mostly with the obligation to others (except the refinancing debt to himself), without a choice of rejection at the very beginning.

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⁴ It should be noted here, that desire to donate, altruistically help to others is the form of satisfaction of own needs. Therefore any needs for the benefit of others in the first round may be aligned with the welfare of individual.
This last stage of the overall process reveals whether the end result of the set of choices, made in the past, had brought projected utility of satisfied need, or not. This is the moment where future uncertainty becomes current state and individual evaluates the results of his choices with the expectation he had at the beginning. If results are at the same level of expectations or higher, the overall process should be seen as Pareto efficient and therefore - just. If the results are lower than expectations, one should look for mistakes of choices made on the way and learn appropriate steps to prevent them in the future.

3.2. Research questions and empirical setting

As mentioned before, the general aim of our research is to investigate the characteristics of the borrower, his choices and consequences in the stream of process, briefly described above as an enhanced Kamleitner – Kirchler model. Thus the core research questions may be summarized and grouped as following: (i) whether the most popular usages of payday credits are all linked to the most basic human needs that cannot be rejected? (ii) whether other (than payday credit) alternatives of financing the needs were accessible to the borrower? (iii) whether at the end of payday credit term most borrowers are able to pay principle and interest? It should be noted, moreover, that in order to reveal most common choice errors, the closer look should be given at the borrowers who acknowledge that they did not received expected utility and thus are not satisfied with the overall transaction.

That is, in order to extract and explain behavioral scripts of payday credit users, the first part of an inquiry shall be linked to the needs of a borrower. If these are all linked to the basic human needs that cannot be rejected, the institutional design should not nudge individual towards rejection of the need. The second step in analysis is to investigate the financing choices available to that individual. If the only financing source left is payday credit and the need of individual cannot be rejected, any restriction to use payday credit may disproportionately harm the borrower. If, however, the needs may be rejected or individual have some obviously better choice available, the task for choice architecture is to nudge individual towards wiser decision. Third and last step in the analysis is to explore how individuals act in the repayment stage. If borrowers repay their debts as they have projected, full transaction should be left for a free market design. However, if borrowers choose to refinance their loans, the process loops creating a risk of error. In case such debt-cycling continues long enough for interest accrued to be higher than utility received from consumption, the overall transaction will have negative value. Such transaction will be welfare diminishing and hence – subject to legislative intervention. Of course, one may always discharge his obligations by going bankrupt. However this is not a real alternative in solving small amount payday credit debt per se.

Hence, after exploring socio – demographic characteristics of our borrowers, we are setting three hypotheses for further challenge:

\[ H1: \text{The most popular usages of payday credits are all linked to the most basic human needs that cannot be rejected;} \]
\[ H2: \text{No other (than payday credit) alternatives of financing the need were accessible to the borrower;} \]
\[ H3: \text{At the end of payday credit term most borrowers are not able to pay principle and interest.} \]

Accordingly, hypotheses that are put for investigation may be shown schematically as a scheme of a debt-cycle (Figure 3). Proving of all hypotheses will lead to a legislative dilemma for further research: how to break the cycle of debt without diminishing access to credit?

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5 Most of the time fairness and effectiveness coincide (Šimašius, 2002)
Figure 3. Scheme of a debt-cycle and hypotheses

H1: The most popular usages of payday credits are all linked to the most basic human needs that cannot be rejected.

H2: No other (than payday credit) alternatives of financing the needs were accessible to the borrower.

H3: At the end of payday credit term most borrowers are not able to pay principle and interest.

The most straightforward and powerful method of determining the scripts of behavior is to ask the person directly (Betti et al., 2007; D’Alessio, Iezzi, 2013), since generally people do not attempt to lie or hide their difficulties (European Commission, 2001). Indeed, the use of survey is common and in the researches of payday lending phenomena (see e.g.: Elliehausen and Lawrence, 2001; Elliehausen, 2009; PEW, 2012; Bertrand and Morse, 2011, etc.). After reviewing the instruments used in these empirical researches, we have developed a questionnaire, consisting of 42 questions, 25 of which are presented as the propositions for evaluation in the 5 grade Likert scale. Questionnaire has been prepared using web-based tool SurveyMonkey® and survey has been performed online6. The structure of questionnaire is presented in Table 1:

Table 1. Structure of questionnaire

<table>
<thead>
<tr>
<th>Name:</th>
<th>Question No.</th>
<th>Statement No.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Situational and personal characteristics</td>
<td>1; 33-36; 38; 39,41,42</td>
<td>10; 19-21; 22-29</td>
</tr>
<tr>
<td>H1: The most popular usages of payday credits are all linked to the most basic human needs that cannot be rejected</td>
<td>3;4</td>
<td></td>
</tr>
<tr>
<td>H2: No other (than payday credit) alternatives of financing the need were accessible to the borrower</td>
<td>4;30</td>
<td>5-9; 11-18</td>
</tr>
<tr>
<td>H3: At the end of payday credit term most borrowers are not able to pay principle and interest.</td>
<td>31,32,37</td>
<td></td>
</tr>
</tbody>
</table>

Calculating the representative sample we have generally relied on the statistics provided by the Central Bank of the Republic of Lithuania (2013, 2014). According to the numbers provided, general population of payday users at the beginning of 2012 was 224.000. Since the legislative environment has been directed towards restriction of the services and the general economy has been growing, by calculating representative sample before survey we

6 https://www.surveymonkey.com/s/apklusa2013
have assumed that the general population will be the same at most. The statistics of transactions for the year 2013, provided by Central Bank of the Republic of Lithuania (2014) after the survey, proves that our assumption was cautiously correct. Having such population, the targeted sample was 1062 payday users per previous 12 months.

Since the survey has targeted payday borrowers and there is no registry of users, in order to reach the target group we have asked three payday lending companies to spread the questionnaire among their clients. Cooperation with payday lenders in the studies of borrower behavior is commonly used by scholars in order to reach target group (see for e.g. Fritzdixon et al, 2013, Bertrand and Morse, 2011 and others), therefore the ethics of the research hasn’t been breached.

The total of 90,233 invitations to conclude the on-line survey has been sent by e-mails, providing the internet link to questionnaire. During the period of 2013-12-05 to 2014-01-13 the total of 2,776 users has started answering the questionnaire, however only 1,734 has completed it in full. 183 respondents had used the service more than 12 months ago, thus we have excluded them from general sample leaving us with 1,551 responses from recent payday loan users. Having in mind, that the samples of well-known researches (e.g. Elliehausen and Lawrence, 2001; Elliehausen, 2009; PEW, 2012; Bertrand and Morse, 2011, etc.) were smaller or about the same on much larger population and still were recognized as sufficient, we also conclude that the sample collected represents general population and thus is susceptible for further investigation.

The limitation of the survey lies generally in the autonomy of respondents. The questions have been answered without any possibility to clarify the meaning of words or expressions, therefore the hermeneutical risk of erroneous understanding persist. However, the same major issues have been double-checked by few different questions in order to extract these mistakes. Moreover, the general number of responses is high, which allows us to assume that mistakes of understanding (if any) do not make any noticeable influence on the validity of results or interpretations therein.

Having it said, in order to present and explain the context of the survey we shall proceed with the brief overview of the rise of payday lending market in Lithuania.

4. Genesis of Payday Lending Market in Lithuania

Unpredicted and sudden economy shock at the end of 2008 has sharply changed marginal utility of money. During the years 2009 and 2010 commercial banks in Lithuania had suffered more loss than they have gained gross profits during the years 2003-2008. Due to such decline, these banks had sharply restricted access to credit, causing lack of financial resources in the market. Such decline was followed by sharp increase of unemployment, disputes related with obligations, mortgage (pledge) defaults and bankruptcy cases thereof.

Such sudden increase of liquidity concerns and marginal utility of money, restricted access to mainstream credit and other factors has created the perfect market place for the third-tier lenders. Except few start-ups in 2007 (or earlier), 20 out of 27 currently active payday lenders were established at the peak of overall economic hardship in 2008 – 2009.

The payday lending industry grew tremendously fast despite high controversy from the very beginning. The analysis of top 3 payday lenders7 (who represents 80% of market) (see Figure 4) shows that starting from almost nothing in 2007, they have reached more than 100 mln. LTL of interest income in 2012. The overall portfolio grew by more than 80 % in 2011 and 32 % in 2012 (Central Bank of the Republic of Lithuania, 2012, 2013).

7 UAB “4Finance” (www.smscredit.lt and www.vivus.lt), UAB “MCB Finance” (www.credit24.lt) and UAB “Moment credit” (www.momentcredit.lt) have approximately 80 % of the market.
Of course, comparing to the mainstream lending, these are relatively small numbers. However, such income has been compounded from the loans, the average amount of which is was approximately 386 LTL, with APR of 100% in 2012 and 2013. That is, the frequency of transactions is very high. There have been almost 800,000 credit agreements made per year in 2012 and 2013 (Central Bank of the Republic of Lithuania, 2013, 2014). That makes almost 34 credit transactions for every 100 persons of legal age (18 and more) in Lithuania. Moreover, easily accessible payday loans, according to the Central Bank of the Republic of Lithuania (2012, 2013), became very attractive source of funding specifically for low income and young households.

Faced with the pressure from media and consumer advocates, Lithuanian legislature has started adopting stringent laws and regulations, which had harshly restricted the provision of payday loans. Arguing the need for hard paternalism, the Director of the Financial Services and Markets Supervision Department of the Bank of Lithuania made many impressive comparisons of payday loans with “treatment of hangovers with alcohol” or “the drug distribution business”. Much of the critic was oriented towards the irrationality and financial illiteracy of consumers. Moreover, he had urged to prohibit payday lending and hand all customers over to banks and credit unions.

However, such hostile approach from the regulators is being upheld without any deeper researches of the reasons for consumer choices and their behavior. It should also be mentioned, in the context of such rhetoric, that in 2012 only 33 complaints were received regarding payday loans, amounting to 0.004 per cent out of all number of the credit transactions (796,131). It follows then, that the motive for hard paternalism comes from over-controversial media, rather than from under-explored behavior of Lithuanian borrowers. Having it said, we shall turn to the discussion of survey results next.

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**Source:** Registry of Legal Persons

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First thing we wanted to extract from the results of survey was the two groups of respondents: (i) ones for whom overall process was useful and (ii) ones who claimed that it was not useful (i.e. harmful). We are assuming that utility of transaction is the direct measure of its effectiveness and thus – effects on welfare. In order to have a representative answer to it, we have designed eight statements from two perspectives: (i) overall experience with payday loan, and (ii) attitude to payday lending service. All statements were presented for respondent evaluation in the 5 grade Linkert scale. The disbursement of answers was as following:

Table 2. Overall experience and attitudes towards payday lending service

<table>
<thead>
<tr>
<th>Perspective with payday loan (Q19-21)</th>
<th>Statement</th>
<th>Strongly agree</th>
<th>Agree</th>
<th>No opinion</th>
<th>Disagree</th>
<th>Strongly disagree</th>
<th>Total (N=1551)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall experience with payday loan</td>
<td>Payday loan was useful for me, because it has provided an opportunity to access funds when it was most needed</td>
<td>57%</td>
<td>37%</td>
<td>3%</td>
<td>2%</td>
<td>1%</td>
<td>100%</td>
</tr>
<tr>
<td></td>
<td>Before taking payday loan I was of better opinion about the service, however I was unpleasantly surprised how hard it is to repay it</td>
<td>10%</td>
<td>16%</td>
<td>13%</td>
<td>39%</td>
<td>22%</td>
<td>100%</td>
</tr>
<tr>
<td></td>
<td>Payday loans hadn’t solved my problems, but had made them worse</td>
<td>9%</td>
<td>12%</td>
<td>11%</td>
<td>35%</td>
<td>34%</td>
<td>100%</td>
</tr>
<tr>
<td>Overall experience with payday loan</td>
<td>Payday loans are useful for most of people</td>
<td>25%</td>
<td>43%</td>
<td>18%</td>
<td>11%</td>
<td>3%</td>
<td>100%</td>
</tr>
<tr>
<td></td>
<td>People borrows irresponsibly because of their own fault, not the fault of payday lending companies</td>
<td>34%</td>
<td>42%</td>
<td>13%</td>
<td>7%</td>
<td>3%</td>
<td>100%</td>
</tr>
<tr>
<td></td>
<td>Government should lower the price of payday loans even if it will lower the access to small amount and short term credit</td>
<td>21%</td>
<td>30%</td>
<td>27%</td>
<td>16%</td>
<td>7%</td>
<td>100%</td>
</tr>
<tr>
<td></td>
<td>Government should limit the number of rollovers available</td>
<td>5%</td>
<td>9%</td>
<td>25%</td>
<td>33%</td>
<td>27%</td>
<td>100%</td>
</tr>
<tr>
<td>Overall experience with payday loan</td>
<td>Payday loans should be banned</td>
<td>5%</td>
<td>3%</td>
<td>9%</td>
<td>27%</td>
<td>55%</td>
<td>100%</td>
</tr>
</tbody>
</table>

The top two numbers (indicated in green) show that generally people had a useful experience. Such opinion on payday lending services remained the same (or better) after the use, since payday loan had helped solving their problems. Moreover, the majority thinks that payday loans are useful for most of people and cases of irresponsible behavior happens because of the fault of the borrowers themselves. Respondents generally disagree with the absolute ban of service or restrictions of rollovers. Although with regard to interest rate restrictions and rollovers, the opinions are generally against restrictions, although not with that clear difference as is seen with the overall experience.

The next step in our setting is to extract personal characteristics of the borrower. We used a typical set of characteristics, common in the studies of the payday lending services: (i) sex; (ii) age; (iii) education; (iv) employment status; (v) income; (vi) type of housing. Compilations of marginal answers allow us to draw a symbolic picture of a typical payday borrower. She is at the age 35-50, with professional / college degree, which lives in her own house, is employed and earning from 1101 to 1500 LTL. That is, typical borrower is not of barely legal age, uneducated and unemployed person, as public opinion might be:

**Figure 5.** Personal characteristics of the borrowers:
Moreover, most of payday borrowers are frequent users, turning to this type of credit once per six months or quarter. Most of the borrowers do not have any difficulties in covering regular expenses and they don’t consider themselves being impulsive. Latter behavioral characteristic is confirmed by corresponding statements regarding budget planning practices:

**Figure 6. Behavioral characteristics of the borrowers:**

<table>
<thead>
<tr>
<th>Frequency of use</th>
<th>Ability to cover regular expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Very rare (have borrowed 1-2 times)</td>
<td>Late every month</td>
</tr>
<tr>
<td>Rare (once per year)</td>
<td>Late most months per year</td>
</tr>
<tr>
<td>Medium (once per 1/2 year)</td>
<td>Late rarer than every second months</td>
</tr>
<tr>
<td>Frequent (once per quarter)</td>
<td>Late very rarely</td>
</tr>
<tr>
<td>Very frequent (once per month)</td>
<td>Always on time</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>I am impulsive buyer</th>
<th>I am planning my budget</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strongly agree</td>
<td>Strongly agree</td>
</tr>
<tr>
<td>Agree</td>
<td>Agree</td>
</tr>
<tr>
<td>No opinion</td>
<td>No opinion</td>
</tr>
<tr>
<td>Disagree</td>
<td>Disagree</td>
</tr>
<tr>
<td>Strongly disagree</td>
<td>Strongly disagree</td>
</tr>
</tbody>
</table>

Although it was not meant to have separate discussion on the financial literacy of the borrowers, a bit unexpected results made us to segregate it from the rest of characteristics. Using a standard calculator, seen on most payday lenders home pages, we have calculated mandatory (by law) set of indicators to a 400 LTL loan for 14 days period. We have received an offer of: (i) 199.7% of Annual Percentage Rate of Charge APRC; (ii) 112.11% of borrowing rate; (iii) 417.20 LTL total amount to pay, i.e. 17.20 LTL of interest.

Having these numbers, we have asked our respondents which offer they would choose if they would be willing to borrow 400 LTL for 14 days, for a cheapest price. We have provided four possible answers: (i) 200% APRC (which is lowest price from all); (ii) 120% of borrowing rate (which is medium price of all); (iii) 20 LTL (which is the most expensive price of all); (iv) any, depending on the speed of transaction. Last answer was provided in order not to lose respondent if he is not willing to do any calculations. The majority (1065 of 1551) have chosen the most expensive price:

11 We used: www.smscredit.lt
12 Directive 2008/48/EC and Lithuanian Law on Consumer Credit requires mandatory disclosure of three price indicators: (i) annual percentage rate of charge (APRC); (ii) borrowing rate; (iii) The total amount borrower will have to pay (principal plus interest)
Moreover, most of the payday borrowers (51%) strongly agreed (or agreed) with the statement that they asked for loan because of cheap price, although it is well known, that such kind of credit is the most expensive one in APRC terms. Having such high rate of what seems to be financial mistakes, we have looked at the education of the respondents who had made them. We found that the biggest rate of mistakes is seen in the highest education holding groups:

Table 3. Borrowers’ price choice:

<table>
<thead>
<tr>
<th>Education</th>
<th>Full group</th>
<th>Chose 20 LTL</th>
<th>% in group</th>
</tr>
</thead>
<tbody>
<tr>
<td>No education</td>
<td>24</td>
<td>15</td>
<td>63%</td>
</tr>
<tr>
<td>School</td>
<td>428</td>
<td>292</td>
<td>68%</td>
</tr>
<tr>
<td>Professional / college</td>
<td>633</td>
<td>438</td>
<td>69%</td>
</tr>
<tr>
<td>University</td>
<td>324</td>
<td>219</td>
<td>68%</td>
</tr>
<tr>
<td>Master of science</td>
<td>137</td>
<td>97</td>
<td>71%</td>
</tr>
<tr>
<td>Doctor of science</td>
<td>5</td>
<td>4</td>
<td>80%</td>
</tr>
<tr>
<td>Total:</td>
<td>1551</td>
<td>1065</td>
<td>69%</td>
</tr>
</tbody>
</table>

Since financial literacy is directly linked with the level of education, such results make us conclude that the intended question on financial literacy actually had shown how people perceive information on the price of credit, not the level of financial literacy itself. This conclusion is supported by a survey question on understanding the APRC, borrowing rate and price in monetary units. Here most of the respondents (75,18%) strongly agreed or agreed with the statement that they better understand price expressed in monetary units than in APRC or borrowing rate. If so, the issue of the level of financial literacy of Lithuanian payday borrowers remains unanswered. However, these conclusions are revealing a serious shortage of the tools that the drafters of Directive 2008/48/EC and Law on Consumer Credit have chosen to indicate the price of credit.

Having it said, we now turn to the process of payday credit use and the choices borrowers make. As was discussed above, the process of transaction consists of the set of three steps: (i) processes before credit take up; (ii) process at credit take up; (iii) process after credit take up. Further results of our survey are explained in the same order.

Part I: processes before credit take up. As a primary question at this stage we have asked directly for what purposes the credit was taken for? We allowed to choose multiple answers for this, asking to indicate the most frequent purposes. As seen from Figure 8, the most popular usages are all linked with the unexpected expenses (funeral, sickness, car or
home appliances maintenance, etc.) and most basic human needs: utilities (water, electricity, etc.) and food.

**Figure 8. Reasons for payday credit use**

Recognizing the hermeneutical risk and fact that for example “food” may be understood as including lobsters and caviar, we also asked respondents what they would have done if last time they used a payday loan, if it would have been inaccessible. Only 18% of respondents replied that they would have refused to satisfy their needs. Others would have done something, and 9% - anything, to get the funds necessary for the needs at stake. This confirms general conclusion that payday loans are usually taken in order to satisfy needs that cannot be rejected, i.e. basic human needs.

Having it said, we turned to an analysis of segregated groups of respondents who had marginally useful and harmful experiences with the overall service. With regard to latter ones, most reasons for payday use were related with unexpected expenses, refinancing of other formal credit and clothing. Here almost 39% of borrowers would have rejected their needs if payday credit would not be accessible and the same 9% were desperate for money and would have done anything to get funds necessary. Comparison of these results reveals that the utility of service is lost mostly if payday credit is taken to cover other debts, clothing or partying, i.e. not for the purpose the service is intended for.

**Figure 9. Segregated reasons for payday credit use**

Having it said the general conclusion might be drawn that payday loans are mostly used for the purpose they are intended to be used – to cover unexpected expenses and satisfy
basic human needs that respondents cannot reject. Harmful effects might be seen if the loan is not used for the purpose it is intended. Hence our thesis that the most popular usages of payday credits are all linked to the most basic human needs that cannot be rejected should be seen as confirmed.

**Part II: process at credit take up.** In order to understand the reasons for choosing payday loan instead of any cheaper alternatives, we have designed the set of 16 questions and statements, regarding the availability of alternatives; reasons for not choosing them; behavior in evaluation of contract terms before credit take-up and expectations (confidence) at the time of application regarding ability to repay.

First of all, we have asked respondent, what would they have done if last time he used a payday loan, it would have been inaccessible. The results are presented in Figure 10.

**Figure 10.** Alternatives available

It seems, on its face, that most of the borrowers have had alternatives available – most of them could have turned to friends and families, others had mainstream credit available or property to sell. It should also be noted, that “default” is also an alternative, however from the perspective of regulator it should not be treated as an option to nudge borrower to. With the same precaution should be treated those, who chose “anything” option. If there is no way to reject ones needs, no property to sell, nor friends and banks to borrow from, an option “anything” does not indicate a legal option at all. At least this meaning was assigned to the question at its drafting stage.

Next step in our analysis was to extract the reasons why respondents had applied to the most controversial and most expensive option. For this purpose we first of all asked whether respondent has tried to apply somewhere else, allowing choosing multiple answers. The results are presented in Figure 11.

**Figure 11.** Reasons not choosing other alternatives
Having in mind, that most of the borrowers has alternatives available, the results indicate that the major driving forces of the payday industry are: (i) the feeling of shame to acknowledge the shortage of funds and ask for help; (ii) unexpected nature of the needs and expedient demand for funds thereof; (iii) financial exclusion from mainstream markets. High numbers of borrowers who had property or savings indicates the classical bias of mental accounting.

In addition we had provided the set of statements for respondents’ evaluation. Majority of them strongly agreed (or agreed) that: (i) they took payday loan because they were ashamed to ask relatives, friends or neighbors (80%); (ii) that they applied for payday loan because of faster lending procedure (91%) that requires less formalities (85%); (iii) that payday loan was the only source of credit available (59%), and they needed a short term small loan, which is generally not available in banks or credit unions (83%).

Having discovered, that although payday loan mostly is the only source of formal credit available to the borrowers (in the context of the nature of their needs), most of them has other legal sources of funding – informal loans and property (savings) to use. The reasons for not asking for help are the feeling of a shame and expedient nature of the needs. Accordingly, it seems that although objectively other sources (credit and non-credit) are available to the most of borrowers, subjectively they are mostly unacceptable or inaccessible.

Moreover, we also had to look at the process of choice. Most of the respondents (72%) strongly disagreed (or disagreed) with the proposition that they would have signed agreement on any terms because of the need of funds. Although majority of borrowers (56%) has evaluated only price and term of the loan paying no attention to other clauses and without any advice of professionals of friends, they have carefully evaluated all alternatives available to this kind of loan (78%). The majority of borrowers (77%) had carefully considered their ability to repay, although most of them thought they will be able to cover it faster than it was in reality (60%). Only 24% of borrowers knew or doubted on their ability to repay the debt. On the contrary – 65% of borrowers had repaid the loan as they have intended. Such evaluation seems to confirm that in general borrowers carefully consider their abilities to borrow and repay. Moreover, in most of the cases they do not miscalculate, although usually they are over-confident with their abilities to repay earlier.

Having it said, the general conclusion that subjectively other sources (credit and non-credit) are unacceptable or inaccessible, although objectively available, is valid. Thus our hypothesis that no other (than payday credit) alternatives of financing the need were accessible to the borrower should be seen as conditionally approved, depending on the perspective of evaluation (objective or subjective).
Part III: process after credit take up. For the final stage of our analysis we have asked whether our respondents rollover their payday loans; what sources has been used to repay them and how much in general they can afford to pay every month for principal and interest, without diminishing their regular expenses.

The results revealed that only 38% of borrowers does not extend the terms of the loan. Others rollover their loans in different frequencies from 1 to 6 times and more (Figure 12).

**Figure 12. Behavior at repayment**

Most of the payday credit are covered by own funds (savings) or from additional employment. Only minorities use another credit sources to cover payday loans (Figure 13).

**Figure 13. Source of repayment**

<table>
<thead>
<tr>
<th>Source of repayment</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Own funds (savings)</td>
<td>55%</td>
</tr>
<tr>
<td>Credit still not covered</td>
<td>26%</td>
</tr>
<tr>
<td>Found additional job</td>
<td>16%</td>
</tr>
<tr>
<td>Other</td>
<td>15%</td>
</tr>
<tr>
<td>Borrowed from other payday lending company</td>
<td>8%</td>
</tr>
<tr>
<td>Unexpectedly received income</td>
<td>5%</td>
</tr>
<tr>
<td>Borrowed from relatives, friends or neighbours</td>
<td>4%</td>
</tr>
<tr>
<td>Sold property</td>
<td>2%</td>
</tr>
<tr>
<td>Borrowed from bank or credit union</td>
<td>2%</td>
</tr>
</tbody>
</table>

The reason for such high rate of rollovers might be found in relatively low sum of credit and interest payments that are affordable to the borrower. From the respondents who agreed to answer, 60% of them could afford only up to 400 Lt (or less) in payments of credit and principal per month (Figure 14). Having in mind that average amount of payday loan in 2013 was 383,5 Lt (Central Bank of the Republic of Lithuania, 2014), which costs approximately 35 Lt\(^{13}\), the maximum amount available barely covers average amount taken.

**Figure 14. Affordable rate of credit payments**

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\(^{13}\) Price for a 400 Lt loan for a period of month at the most popular provider UAB “4Finance” [www.smscredit.lt](http://www.smscredit.lt) is 37,60 Lt.
Having it said, we have compared how the rollovers were used by ones who stated that they have returned payday loan as they have planned; ones, who stated that it took longer as they thought it will be and ones, who had disagreed or strongly disagreed with the statement, that payday loan was useful for them. From the results we may confirm our assumption made before, that utility of the service is directly linked with the times the rollover was used.

**Figure 15.** Repayment process of different groups of respondents

<table>
<thead>
<tr>
<th>Repayment process:</th>
<th>As planned:</th>
<th>Took longer:</th>
<th>Dissatisfied:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Did not rollover</td>
<td>53%</td>
<td>26%</td>
<td>15%</td>
</tr>
<tr>
<td>Did rollover 1 time</td>
<td>17%</td>
<td>12%</td>
<td>17%</td>
</tr>
<tr>
<td>Did rollover 2-3 times</td>
<td>15%</td>
<td>20%</td>
<td>20%</td>
</tr>
<tr>
<td>Did rollover 3-6 times</td>
<td>7%</td>
<td>18%</td>
<td>11%</td>
</tr>
<tr>
<td>Did rollover more than 6 times</td>
<td>8%</td>
<td>23%</td>
<td>37%</td>
</tr>
</tbody>
</table>

Therefore we may conclude that payday borrowers are struggling with the repayment of payday loans and frequently rollover them. Moreover, the rollovers are directly linked with the overall utility of services. Therefore the hypothesis that at the end of payday credit term most borrowers are not able to pay principle and interest should be treated as confirmed.

5. In lieu of Conclusions

As we have seen from the above, the access to credit for households deserves special scrutiny and very careful regulation in order to avoid unreasonable and severe consequences. The regulator should study the behavioral patterns of the borrowers and analyze why one chooses payday loans and what are the consequences of such choice. Accordingly, the legislative policies should aim to maintain or increase freedom of choice, attempting to nudge people towards the right choices, or help to cope with the consequences. Harsh restrictions and bans may disproportionally harm ones that acts rationally.

Applying the logics of an enhanced Kamleitner and Kirchler (2007) model and extensive survey of borrowers we found that typical borrower is not of barely legal age, uneducated and unemployed person, as public opinion might be. Moreover, absolute majority of respondents evaluated the payday lending service as useful, despite the relatively high price of the loan. This may be explained by the interests borrower protects by taking the loan. We found and conclude that the most popular usages of payday credits are all linked to the most basic human needs that cannot be rejected. Accordingly, any restrictions of credit access might violate most of the borrowers’ right to credit. Moreover, we found that although objectively other finance sources are available to the borrower, subjectively they are
una acceptable - mostly because of the shame to ask for help. This is exactly the place where legislature may paternalistically nudge person to the alternatives accessible. Finally, as was expected, the real problem lies in the process of repayment. Although much of the respondents had no problems in planning and repaying their debts, most of the borrowers at the end of payday credit term were not able to pay principle and interest and thus used the rollover or refinanced their loans. Once again, this is exactly the place where regulators should pay their full attention in order to break the cycle of debt without diminishing access to credit. However - what is the right regulation? By setting the conceptual and empirical background for a discussion on the model of regulation of payday lending services, we will elaborate on this issue in the future researches.

References


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