Research Working Papers

Employer Credit Checks: Poverty Traps versus Matching Efficiency

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Banning pre-employment credit screening may help people improve bad credit scores but may reduce firms' overall productivity.

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We develop a framework to understand the effects of pre-employment credit screening in both labor and credit markets. People differ in both their propensity to default on debt and the profits they create for firms that employ them. In our calibrated economy, workers with a low default probability are highly productive and therefore generate more profits for their employers; thus, firms create more jobs for those with good credit. However, using credit reports to screen job applicants creates a poverty trap: an unemployed worker with poor credit has a low job-finding rate and cannot improve their credit without a job. In the calibrated economy, this manifests as an endogenous loss in the present value of lifetime wages that is roughly half of the amount widely used in quantitative models of consumer default. Banning employer credit checks eliminates the poverty trap, but job seekers with good and bad credit now apply to the same jobs, which reduces matching efficiency. As a result, average job-finding rates fall 1.3 percent for high-productivity workers and rise by 1.7 percent for low-productivity workers.

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