The Fee Neutrality Claim
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Will reduction in interchange fees help or hurt consumers? Two posts yesterday made the conjecture that a reduction in one category of fees would only increase other fees, and that the overall sum of fees will not change. This is the fee-neutrality claim. Todd Zywicki writes:

> The mathematics of the situation is inescapable: card issuers would have to increase the revenue generated from consumers from either interest payments or higher penalty fees.

And Josh Wright agrees:

> It would be unwise from a consumer protection policy standpoint to assume that [reduction in interchange fees] represent the free lunch legislators have been looking for after all these years – or that those fees will not simply be reinstated in other guises elsewhere.

As a logical claim, I tend to agree with this "neutrality" conjecture. Indeed, the Australian experience can be explained in a way that is consistent with this dynamic, as Joshua Gans noted:

> The interchange fee reduction causes merchant fees to fall but issuer fees to rise (or loyalty schemes to be curtailed) but otherwise does not impact on the consumer's choice of payment instrument.

The question, though, is what are the implications of fee neutrality. Zywicki and Wright conclude, I believe, that in light of fee neutrality, it is pointless to try to help consumers by capping one component of the overall fee. It will not help, and might introduce an inefficiency.

My claim in this post is that the normative implications are not necessarily as Zywicki and Wright suggest. Fee neutrality, as I understand, applies only to the average cost of using credit cards. That is, consumers who use credit cards end up paying on average the same economic cost, regardless of the division of fees. But when we consider other measures of consumer welfare, the neutrality claim no longer holds.

First, consumers who use credit cards as payment device and not for borrowing would benefit from the fee substitution. For them, the lower product prices when interchange fees decline are not offset by higher finance charges, because they don't pay finance charges. So even if the neutrality proposition is correct on average, limits on fees have a distributive effect. This effect could also change the relative uses consumers make. Buying things becomes cheaper, borrowing becomes more expensive, and so we can predict some shift in primary conduct, which, again, violates the neutrality conjecture.

Second, even if for a given consumer the increase in finance and other charges exactly offsets the reduction in interchange fees, it is plausible to expect that a reduction in fees would lead to a reduction in prices of products and change the consumer's purchasing decisions. Imagine that the interchange fee were to drop, in a hypothetical economy, from 5% to 0.5%. Do we think that product prices will drop accordingly? In response to a comment I posted yesterday, suggesting that such a price decline would occur, Todd Zywicki correctly responds that not all the saving will be rolled over to consumers. It depends on cross-elasticities of demand and supply. But at least in competitive markets, where prices equal marginal cost, the bulk of the savings in interchange fees would be enjoyed by consumers. It may be that nominal prices would display some stickiness, but it's hard to imagine that in the long run consumers will be deprived of this benefit. One has to have very little faith in markets to imagine that the cost reduction will be enjoyed in its entirety by merchants, through higher profits.

If caps on interchange fees cause a non-trivial effect on prices, this regulation has the potential to reach far beyond the credit card market. It now affects primary decisions regarding the composition of consumption.

It is true that some of the increased demand due to lower prices is offset by the higher cost of credit. To buy these cheaper products with borrowed money would be just as costly, according to the neutrality claim. But it is important to unbundle the overall price into its two pure costs—the cost of the product and the cost of the credit. The potential efficiency of fee limits is in achieving an unbundled price, where the product component and the price component are priced separately.

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