Politically-Mandated Credit Card Interchange Fees Won’t Create Jobs (But They Will Hurt Consumers and the Economy)
March 21, 2010
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Cross-posted at Business in the Beltway (at Forbes.com) and The Volokh Conspiracy.

In a recent commentary at Forbes.com, former Clinton administration economist Robert Shapiro argues that some 250,000 jobs would be created, and consumers would save $27 billion annually, by reducing the interchange fee charged to merchants for transactions made by consumers using credit and debit cards. If true, these are some incredible numbers.

But incredible is indeed the correct characterization for his calculations. Shapiro’s claims, based on a recent study he co-authored, rest on tendentious accounting, questionable assumptions, and—most crucially—a misunderstanding of the economics of interchange fees. Political price caps on interchange fees won’t help the economy or create jobs—but they will make consumers poorer.

First, Shapiro estimates the employment impact of a redistribution of fees using the same stimulus multiplier that the Obama administration uses to tout the effect of its stimulus package. But it is completely inappropriate to simply “plug in” the multiplier for government stimulus to calculate the effect of a reduction of interchange fees —unless the interchange fees currently paid to banks somehow simply disappear from the economy, contributing nothing to job creation, lowering the cost of capital, or increasing access to credit. Even assuming that some portion of the fees are pure profit for card issuers, those profits must be paid out to shareholders or employees, invested, or used to bolster bank balance sheets (which provides capital for lending). So, unlike the stimulus, this is at best merely a politically-mandated wealth (and employment) redistribution from card issuers to merchants, and any calculation of apparent economic gain must be offset by a similar calculation of loss on the other side. Having ignored this offset, Shapiro’s conclusions are completely untenable.

But Shapiro also misunderstands the economics of payment card networks and the role of the interchange fee within them. For example, Shapiro estimates that 70% of merchant savings from reduced interchange fees would be passed on to consumers in the form of lower retail prices. But that is pure speculation. In Australia, where regulators imposed price controls on interchange in 2003, fees paid by merchants have fallen but consumers
have seen no reduction in the prices that they pay. And where merchants have been permitted to impose surcharges on credit users, the surcharge can, and often does, substantially exceed the interchange fee cost. It is not for nothing that merchants have spent millions trying to push interchange fee regulation through Congress.

In addition, Shapiro suggests that interchange fees are excessive in light of the “transaction and processing costs of using credit and debit cards.” But his estimation of these costs is dramatically off-base. Not only does he appear to exclude the cost of the delay between the time merchants receive payment (almost immediately) and when consumers pay their bills (at the end of a billing cycle), he ignores what may be the most significant single cost of consumer credit operations (and corresponding benefit to merchants): the cost of credit loss.

According to the industry standard Nilson Report, in 2009 issuers of Visa and MasterCard credit cards simply wrote off—never received payment for—about 5% of the total value of credit card purchases, a cost of about $65 billion. Why a cost? Because although cardholders failed to make good on $65 billion in commitments to pay for charges they incurred, issuing banks nevertheless transferred these funds to merchants as if they were paid. In exchange for no more than $26 billion in interchange fees for these credit cards in 2009, therefore, merchants received a benefit—revenue they would otherwise simply not have received—worth $65 billion. But this never shows up in Shapiro’s analysis—nor does it ever seem to factor into merchant claims that interchange fees are “too high.”

Interchange fees are the primary mechanism credit card issuers use to generate revenues from transactional users who don’t revolve balances. If interchange fee revenue is arbitrarily reduced, issuers will be forced to increase prices on cardholders through annual fees, interest rates or other fees. At the same time, issuers will need to reduce their risk of credit loss through shorter grace periods, lower credit limits, or tougher credit standards. A reduction in interchange fee revenue would fall especially hard on community banks and credit unions that rely heavily on interchange fees because their customer base tends to revolve less and pay less in penalty fees than the big issuers. Artificially reducing interchange fees would likely drive many of these issuers out of the market, reducing competition and consumer choice.

While the assertion of “pass-through” savings to consumers by merchants is speculative, what is not speculative is that card-using consumers will pay more and get less access to credit if interchange fees are set by politics rather than markets. Again, the outcome of the Australian experiment with interchange price controls demonstrates this trade-off. There, following the price controls, annual fees increased by 22% on standard cards and by as much as 77% on rewards cards. The overall effect is to make it more expensive for consumers to even hold, let alone use, cards, stifling competition and innovation in the credit card industry. And higher annual fees mean less money to spend at the local hardware store, a tradeoff that Shapiro nowhere acknowledges. Moreover, because the fees don’t vary based on charge volume (which tends to vary with income), they are somewhat regressive in their impact. Finally, it is worth noting that while merchants share the burden...
of interchange fees, they do not directly bear any of the cost of interest payments or annual fees, leaving consumers to bear the brunt of the “benefit” from capping interchange fees.

A reliable cost-benefit analysis of interchange regulation must consider all of these tradeoffs, along with many others; Shapiro’s analysis considers none of them.

Following Shapiro’s lead would invariably lead to higher prices for consumers and less innovation and competition in the credit network. If successful, his efforts would dampen the move to a cashless society, and would politicize the business relationships between merchants, consumers and credit cards issuers. None of this will create jobs or help consumers in the long run—although it might help merchants in the short run. Congress should ignore fuzzy, “costless” accounting that perversely cloaks a redistribution of consumer wealth to retailers as a consumer protection initiative.

This post was co-authored with Todd Zywicki (former Director, Office of Policy Planning at the Federal Trade Commission; Foundation Professor at George Mason University School of Law; and Senior Scholar at the International Center for Law & Economics).

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