

State Regulation of Interchange Fees

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Executive Summary

Payment cards generate significant benefits for both merchants and consumers. Consumers benefit from convenience, security, and rewards. Merchants benefit from enhanced security, as well as higher throughput and larger per-ticket sales.

These benefits are made possible through the interchange fees retained by issuing banks, which fund network infrastructure, fraud prevention, and rewards programs, balancing payment networks' two-sided markets (consumers and merchants).

Big-box merchants have long pushed for regulations that would limit interchange fees. They still want the benefits from card payments, but without paying their part of the costs associated with maintaining the system. Regulations to impose price controls on interchange fees, such as the Dodd-Frank Act's Durbin amendment, have benefited these big-box retailers at the expense of consumers and smaller merchants.

The latest ruse by merchants is to demand that issuing banks be prohibited from retaining interchange fees on sales tax (and, in some cases, other items as well). To date, only one state, Illinois, has passed such legislation. Its Interchange Fee Prohibition Act (IFPA) would prevent card issuers from retaining interchange fees on taxes and tips.

The costs to implement the IFPA or similar legislation in other states would be enormous. Specifically:

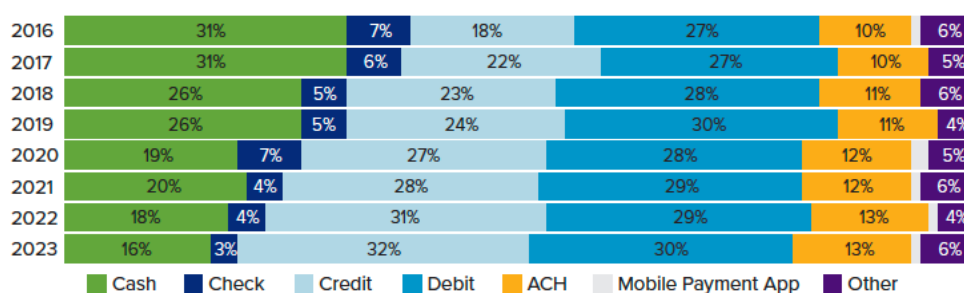
- Merchants would likely see a fall in card use, resulting in reduced throughput and lower revenue. Smaller merchants would lose out relative to larger merchants.
- Banks and credit unions would lose revenue. Smaller local banks and credit unions would be hit worse due to their relative inability to distribute costs.
- Consumers would likely see reduced card rewards and other benefits, as banks compensate for lost revenue.
- State and local governments might see an increase in the costs of enforcing sales tax and a fall in revenue due to reduced economic activity.

Instead of falling for the big-box merchants' ruse, state governments should seek ways to improve the efficiency of collecting sales tax.

I. Introduction

Over the past half-century, payment cards have transformed the way we pay for goods and services. The Federal Reserve Board’s 2024 Diary of Consumer Payment Choice found that, in 2023, consumers made roughly 62% of their payments using credit and debit cards, up from 45% as recently as 2016, while their use of cash and checks has halved, falling from 38% to 19% over the same period (Figure 1).¹ Meanwhile, consumers demonstrably prefer to pay by card. A recent *Forbes* poll found that 70% of Americans use cards most often, while 7% used digital wallets and 1% used buy-now-pay-later schemes.²

FIGURE I: Share of Payment-Instrument Use for All U.S. Payments, 2016-2023



SOURCE: Federal Reserve Board Diary of Consumer Payment Choice

A. The Benefits of Card Payments

This shift in payment choice has been driven by the benefits consumers and merchants derive from cards. For consumers, these include:

- **Convenience:** Consumers can make purchases, both locally and internationally, without having to carry large amounts of cash on their person. Increasingly, they can “tap-and-go,” making contactless payments quickly and effortlessly with a wide range of devices (cards, phones, watches, rings).³ Importantly, cards have also enabled consumers to pay online, which has resulted in a revolution in commerce.⁴

¹ Berhan Bayeh, Emily Cubides, & Shaun O’Brien, 2024 Findings from the Diary of Consumer Payment Choice, FEDERAL RESERVE FINANCIAL SERVICES (May 2024), available at <https://www.frbservices.org/binaries/content/assets/crsocms/news/research/2024-diary-of-consumer-payment-choice.pdf>, (noting that “The category “other” includes payments made with pre-paid [debit], checks, and money orders.”).

² Katherine Haan, *People Are Twice As Likely To Spend More Money When Using Card Than Cash In 2024*, FORBES ADVISOR (May 16, 2024), <https://www.forbes.com/advisor/business/software/people-twice-likely-spend-using-card-than-cash>.

³ *One for the Road*, CURVE, <https://www.curve.com/en-gb/wearables> (last accessed Nov. 14, 2024).

⁴ Among other things, online commerce has improved price transparency and created new markets for “long-tail” products and services. It also played an important role during the COVID-19 pandemic, enabling consumers to continue to make purchases and thereby reducing harms from lockdowns and the disease itself.

- **Security:** Payment cards offer consumers considerable protection against fraud and theft, leaving them far safer than carrying cash. Contactless (tap) and chip (dip) payments do not share underlying payment-account numbers with merchants, and information is encrypted end-to-end, making it almost impossible to steal usable cardholder information. Meanwhile, if a cardholder loses their card, they can easily freeze or cancel it to prevent unauthorized use.
- **Zero Liability:** In the unfortunate event that a fraudulent charge is made, issuing banks assume liability for practically all charges that were not expressly authorized by the cardholder.
- **Record Keeping:** Payment cards automatically keep track of purchases, making it easier to monitor spending, to budget, and to track payments for returns or disputes.
- **Rewards, Insurance, and Other Benefits:** Many credit cards offer rewards programs that allow consumers to earn cashback, airline miles, or points for purchases. Most rewards cards also provide access to special discounts and promotional offers. Many cards offer purchase-protection insurance, extended warranties on purchases, travel insurance, rental-car insurance, and other benefits.
- **Building Credit:** Regular and responsible use of credit cards can help consumers build or improve their credit score, making it easier to get loans or better interest rates in the future.
- **Consumption Smoothing:** Credit cards allow households to defer payment on purchases, enabling them to better manage their cash flow. Credit cards also provide a line of credit that can be useful in emergencies when cash is not immediately available.

For merchants, payment cards offer largely corollary benefits. In particular:

- **Ticket Lift:** The ability for consumers to make purchases larger than the amount of cash they have in their wallet results in increased spending.
- **Increased Throughput:** When consumers pay by card or mobile device—especially when “tapping” (*i.e.*, using contactless systems)—transactions are now generally faster, which means stores are able to process more customers more quickly with fewer staff, resulting in higher throughput.
- **Reduced Security Expenditures:** Cash payments expose merchants to the risk of theft, both in-store and when moving cash to and from the bank. To reduce this risk, stores must invest in both in-store security systems and in armored-car services to collect cash and take it to the bank. Card payments reduce—and, in the case of cashless systems, eliminate—this expenditure.
- **Reduced Skimming:** While modern checkout systems often limit opportunities for checkout staff to skim (*e.g.*, barcode scanners that limit opportunities to input incorrect prices), theft remains a problem in many smaller stores.

As a result of these various benefits, the net cost of card payments (*i.e.*, taking into account the fees charged by acquirers) is generally lower than the net cost of cash.⁵ As an example, one year after

⁵ Julian Morris & Ben Sperry, *The Cost of Payments: A Review*, INT’L CTR. L. & ECON. (Aug. 28, 2024), available at <https://laweconcenter.org/wp-content/uploads/2024/08/cost-of-payments-review-1.pdf>.

switching to a fully cashless payment system in 2018, Atlanta’s Mercedes-Benz Stadium reported that average wait times had fallen by 20 to 30 seconds and per-capita food and beverage sales had risen by 16%, while saving more than \$350,000 in operating expenses.

B. The Role of Interchange Fees

The ubiquity of card payments makes it easy to take them for granted. But that would be a mistake. The transition from cash and check to electronic payments has been a result of decades of investment by card networks, banks, and other parties in the payments system. It is fair to say that payment networks are a marvel borne of innovation and incentives, both of which have been facilitated largely by the “interchange” fees that issuing banks keep. This subsection explains how interchange fees work and why they are important.

1. Scale economies, network effects, and two-sided markets

Most products only become viable when production reaches a certain scale. Often, this is reinforced by network effects, where one person’s use of a product increases its value for others. Examples include typewriter keyboard layouts (e.g., QWERTY), video-cassette formats (e.g., VHS), and social networks (e.g., Facebook, X, etc.).⁶

In some cases, network effects involve two or more sets of market participants. For example, owners of USB-C chargers and cables are more likely to buy devices with USB-C inputs for power and information; meanwhile, manufacturers are more likely to install USB-C inputs when large numbers of consumers own USB-C cables and charges. This is known as a “cross-side” network effect, because it occurs across two inter-related—or “two-sided”—markets (i.e., the market for devices and the market for chargers and cables).

Payment systems are an example of just such a two-sided market with cross-side network effects. For a payment system to become viable requires scale among *both* buyers (one side) and merchants (the other side). If there are too few buyers using the payment system *or* too few merchants accepting it, the system will collapse. By contrast, as the proportion of buyers using a particular system increases, the proportion of sellers accepting it will likewise increase, and vice versa.

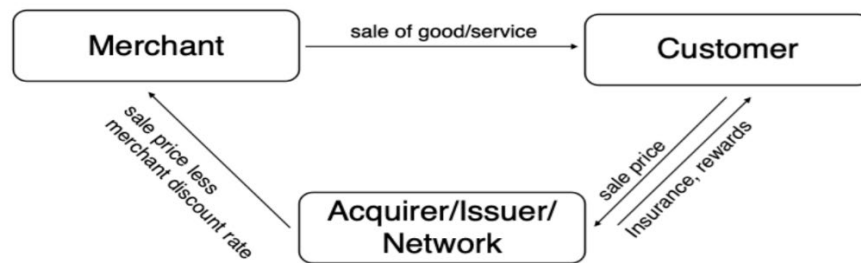
⁶ Stan Liebowitz & Stephen Margolis, *Path Dependence, Lock-In and History*, 11(1) J.L. ECON. & ORG. 205–226 (Apr. 9, 1995); STAN LIEBOWITZ & STEPHEN MARGOLIS, *WINNERS, LOSERS, & MICROSOFT: COMPETITION AND ANTITRUST IN HIGH TECHNOLOGY*, The Independent Institute (1999); Brian Arthur, *Competing Technologies, Increasing Returns, and Lock-In by Historical Events*, 99(394) ECON. J. 116–131 (Mar. 1989).

To grow and maintain a two-sided market, it is often necessary for one side to subsidize the other. Economic theory predicts that the less price-sensitive side will subsidize the more price-sensitive side.⁷ For example, advertisers subsidize the production of newspaper content, resulting in more newspaper readers and more eyeballs for advertisements. Likewise, advertisers subsidize the development of better search-engine algorithms, increasing the number of searches performed on that search engine and the number of impressions for advertisements.

2. Interchange fees and merchant-discount rates

In the case of payment networks, these cross-side subsidies can include collection, payment default, fraud monitoring, various kinds of insurance, and other account-related costs, as well as rewards such as cashback and airline miles. They also include fees to the network operator, which cover not just the operation and maintenance of the network, but also investments in innovations such as the EMV chip, contactless payments, and 3DS, all of which help to reduce fraud.⁸

FIGURE 2: Transactions in a Three-Party Card-Payment System



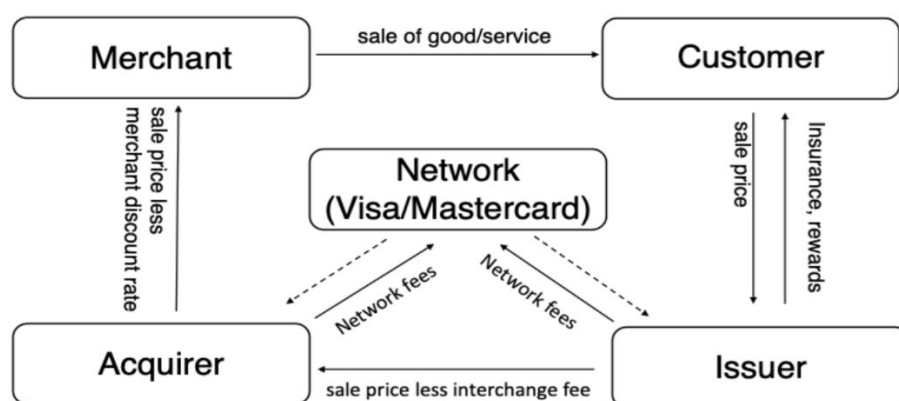
The mechanism by which these subsidies are applied varies, depending on whether the card network is “three-party” or “four-party.” Three-party card networks like American Express and Discover act as card issuer, merchant acquirer, and network operator. As such, they subsidize cardholders directly via fees charged to merchants. This is shown in Figure 2.

⁷ See Todd J. Zywicki, *The Economics of Payment Card Interchange Fees and the Limits of Regulation*, INT’L CTR. L. & ECON. (Jun. 2, 2010), at 33, available at https://laweconcenter.org/images/articles/zywicki_interchange.pdf (economists use the term “price elasticity,” where less elastic means more price-sensitive and vice versa); Marc Rysman, *The Economics of Two-Sided Markets*, 23 J. ECON. PERSPECT. 125 (2009).

⁸ James Cooper & Todd J. Zywicki, *A Chip off the Old Block or a New Direction for Payment Card Security: The Law and Economics of the U.S. Transition to EMV*, 2018 MICH. ST. L. REV. 869 (Mar. 8, 2017); *What Are EMV Chip Cards? How EMV Works and Why It’s So Secure*, STRIPE (Feb. 2, 2023), <https://stripe.com/gb/resources/more/what-are-emv-chip-cards>; *Visa Reports EMV® 3DS Delivers 35% Less Fraud, More Approvals, Superior Shopping Experience*, PYMNTS (Dec. 16, 2021), <https://www.pymnts.com/news/security-and-risk/2021/visa-reports-emv-3ds-delivers-less-fraud-more-approvals-shopping-experience>.

In four-party networks, acquirers subsidize cardholders through the “interchange fee,” which issuers deduct from the amount remitted to the acquiring bank. The merchant’s acquiring bank, in turn, covers both the cost of interchange fees and its own costs by charging merchants a fee known as the merchant discount rate (MDR). These transactions are shown in Figure 3.

FIGURE 3: Transactions in a Four-Party Payment-Card Network



In principle, banks could establish interchange fees with one another. There are, however, roughly 4,000 banks in the United States.⁹ For each of those banks to set interchange fees with one another would require more than 8 million separate agreements.¹⁰ That would clearly be enormously time-consuming and costly. Unsurprisingly, a more efficient solution emerged early in the development of card networks, with the network operator setting default multilateral interchange fees.

The merchant fees charged by three-party networks and the interchange fees retained by issuing banks in four-party networks must be set at levels that effectively balance various competing interests. Given the wide variety and frequently varying characteristics of different merchants and consumers, as well as dynamic competition among issuers, the optimal fee level cannot be identified objectively. Rather, fee levels are an emergent property of the system that vary by type of card and merchant, and are set at levels intended to maximize value for all participants.¹¹ The U.S. Supreme Court put it succinctly in *Ohio v Amex*:

⁹ See *FDIC Statistics at a Glance*, FEDERAL DEPOSIT INSURANCE CORPORATION (Jun. 30, 2024), available at <https://www.fdic.gov/system/files/2024-08/fdic-2q2024.pdf> (as of June 30, the FDIC listed 3,985 commercial banks and 554 savings institutions.).

¹⁰ The number of agreements required is $n(n-1)/2$, where n = number of banks.

¹¹ William F. Baxter, *Bank Interchange of Transactional Paper: Legal and Economic Perspectives*, 26 J. L. & ECON. 541, 577-78 (1983); Zywicki, *supra* note 7.

To optimize sales, the network must find the balance of pricing that encourages the greatest number of matches between cardholders and merchants.¹²

C. The Push for Price Controls on Interchange Fees

Despite the systemic benefits that arise from the payment networks' interchange fees, larger merchants have persistently sought to reduce those fees. In some cases, they have done this through bilateral agreements.¹³ More often, however, they have sought to use political and/or regulatory intervention to impose price controls on interchange fees.¹⁴

One probable reason for this is that larger merchants benefit from scale economies, which means that interchange represents a larger proportion of their MDR than for smaller merchants. As such, interchange-fee price controls tend to benefit large merchants disproportionately relative to smaller merchants.¹⁵

This campaign to lower interchange fees has been waged globally and, in many cases, has been successful, with politicians and/or regulators acceding to large merchants' demands. In the United States, Congress passed an amendment to 2010's Dodd-Frank Act that called on the Federal Reserve to impose price controls on the debit-card interchange fees retained by large banks.¹⁶

Over the past few years, representatives of large merchants have sought repeatedly to pass legislation at the state level that would prohibit issuers from retaining interchange fees in connection with the sales-tax portion of a transaction.¹⁷ Until 2024, none of these attempts were successful. But in June

¹² *Ohio v. Am. Express Co.*, 585 U.S. 529, 545 (2018).

¹³ For example, in the United States, Costco has a co-branded card issued by Citibank and an exclusive arrangement with Visa. See Robin Sidel, *Costco Names Citi, Visa as New Credit Partners*, WALL ST. J. (Mar. 2, 2015), <https://www.wsj.com/articles/costco-names-citi-visa-as-credit-partners-1425302174>; Meanwhile, in Canada, Costco has a co-branded card issued by Canadian Imperial Bank of Commerce (CIBC) and an exclusive arrangement with Mastercard. See *CIBC Becomes the Exclusive Credit Card Issuer for Costco Mastercards in Canada and Acquires Existing Costco Canadian Credit Card Portfolio*, TORYS (Mar. 2, 2022), <https://www.torys.com/en/work/2021/09/3fae5f0b-5d63-484e-a66e-f27b3b35dd64>.

¹⁴ Julian Morris, Todd J. Zywicki, & Geoffrey A. Manne, *The Effects of Price Controls on Payment-Card Interchange Fees: A Review and Update*, INT'L CTR. L. & ECON. (Mar. 4, 2022), available at <https://laweconcenter.org/wp-content/uploads/2022/03/Payments-2021-Lit-Review.pdf>; Eliana Garcés & Brent Lutes, *Regulatory Intervention in Card Payment Systems: An Analysis of Regulatory Goals and Impact*, SSRN (Sep. 21, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3346472.

¹⁵ *Id.*

¹⁶ Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th CONG. § 2 (2010); Regulation II, *Debit Card Interchange Fees and Routing*, 76 FED. REG. 43,393, 43,475 (Jul. 20, 2011), available at <https://www.federalreserve.gov/aboutthefed/boardmeetings/frn-reg-ii-20231025.pdf>.

¹⁷ Glenn Grossman, *The Harmful Impacts of Removing Sales Tax from Interchange Calculations*, CORNERSTONE ADVISORS (2023), available at https://protectinterchange.com/wp-content/uploads/2024/01/23-Harmful-Effects-Removing-Sales-Tax_Cornerstone.pdf.

2024, Illinois passed the Interchange Fee Prohibition Act (IFPA), which would prohibit payment-card issuers from retaining interchange fees related to taxes and gratuities.¹⁸ To our knowledge, this is the first time any government anywhere in the world has imposed restrictions on the retention of interchange in relation only to part of the total transaction amount. As such, there is no direct comparison from which to glean evidence of likely effects.

Illinois' groundbreaking legislation is due to come into effect July 1, 2025, barring a subsequent veto or successful legal challenge.¹⁹ Pennsylvania also recently introduced a law that would prohibit issuers from retaining interchange fees on sales tax.²⁰ Meanwhile, Georgia, Tennessee, and Florida have established committees to study the potential effects of such a law.²¹

Proponents of the elimination of interchange fees on sales tax typically highlight the amount merchants currently pay in such fees.²² In so doing, they seek to imply that if interchange fees on sales tax were eliminated, merchant revenue would increase by those amounts. In practice, however, the effects on merchants would vary considerably, depending on the type of acquiring account they have and the mechanism(s) by which the interchange fees are removed or rebated.

Merchants who use a gateway, such as Stripe or Square, currently pay a “blended” MDR that is set nationally, and would therefore not see any MDR reduction. It seems likely that most other acquirers who offer blended MDRs would not reduce their rates either, as they would incur additional costs associated with implementing the interchange-fee carveout, which would be passed through to their merchant customers. Indeed, it is possible that the implementation costs to acquirers would be sufficient that they would *increase* their blended MDR.

¹⁸ Ill. Gen. Assem., 815 ILCS 151, Interchange Fee Prohibition Act, 1 et seq. (2024), <https://ilga.gov/LEGISLATION/ILCS/ilcs3.asp?ActID=4515&ChapterID=67>.

¹⁹ See *Illinois Bankers Association et al. v. Kwame Raoul*, Case No. 1:24-cv-07307 (N.D. Ill., Aug. 15, 2024), <https://www.aba.com/-/media/documents/amicus-briefs/legal-action/20240815-illinois-interchange-complaint-as-filed.pdf?rev=64eea57a872d41a68c93a5ba91c2c38b>.

²⁰ Tom Nawrocki, *Pennsylvania Weighs Eliminating the Swipe Fee on Sales Tax*, PAYMENTS JOURNAL (Jun. 24, 2024), <https://www.paymentsjournal.com/pennsylvania-weighs-eliminating-the-swipe-fees-on-sales-tax>.

²¹ Andrew Gins, *Measure to “Study” Manipulating Interchange Fees & Sales Tax Sneaks Into Florida Budget*, AMERICANS FOR TAX REFORM (Mar. 14, 2024), <https://www.atr.org/measure-to-study-manipulating-interchange-fees-sales-tax-sneaks-into-florida-budget>; Ga. Gen. Assem., HR 1135, House Study Committee on Credit Card Fee on State Sales and Excise Tax and Their Impact on Georgia Merchants and Consumers, Reg. Sess. 2023-2024 (2024), <https://www.legis.ga.gov/legislation/67081>.

²² See, e.g., Christian Johnson, *How Much Interchange Was Paid on Sales Tax in the U.S.?*, CMSPI BLOG (Oct. 16, 2024), <https://cmspi.com/how-much-interchange-was-paid-on-sales-tax-in-the-us>.

Illinois' IFPA seems to anticipate this effect and offers merchants an alternative means to recover interchange fees from the issuer: submitting a request for reimbursement to their acquirer within 180 days of the transaction.²³

By contrast, larger merchants who are on “interchange plus” MDRs would presumably see a reduction in the interchange component of their MDRs. But they would likely also see an increase in the “plus” component that covers the acquirer's costs. Plausibly, this could come in the form of an increase in fixed per-transaction charges, since the additional administrative cost is not contingent on the size of transaction. Thus, higher-volume, lower-ticket-size merchants could see their MDR costs increase, while lower-volume, higher-ticket-size merchants could see their MDR costs fall. But as discussed in this paper, much will depend on precisely how the law is implemented.

This paper seeks to adduce the likely effects of the IFPA, as well as similar regulations currently being contemplated in other states. To put these regulations into perspective, Section II offers broader context, explaining the increasingly important role that sales taxes play in funding government, the importance of efficient tax collection, and equity issues related to businesses collecting sales and other taxes, before concluding with a brief discussion of compliance cost rebates and some related questions regarding businesses' collection of other taxes.

Section III describes the nature and mechanics of excluding sales tax (and other items) from interchange, and the likely implications of the various methods. Section IV adumbrates the likely implications of such regulations for merchants, consumers, banks, and government revenue. And the brief concludes in Section V with an alternative policy proposal.

II. Taxes Applied at the Point of Sale: Economic and Equity Considerations

From an economic perspective, sales taxes are generally superior to taxes on income or capital because they are less distortionary. While all taxes reduce the amount of capital available for investment, sales taxes provide incentives for saving over consumption, thereby increasing both current investment and future spending. By contrast, taxes on income and capital disincentivize work and investment. All other things being equal, when governments raise revenue via sales taxes instead of taxes on income or capital, rates of economic growth are likely to be higher.²⁴

A 2008 study undertaken by a group of OECD economists offered empirical analysis of the effect of different types of tax, concluding that:

²³ See Interchange Fee Prohibition Act § 150-10 (b), *supra* note 18.

²⁴ See Robert E. Hall, *Consumption Taxes Versus Income Taxes: Implications for Policy*, 61 NAT'L TAX ASS'N, (1968), <https://www.jstor.org/stable/23407742>.

Corporate taxes are found to be most harmful for growth, followed by personal income taxes, and then consumption taxes. Recurrent taxes on immovable property appear to have the least impact. A revenue neutral growth-oriented tax reform would, therefore, be to shift part of the revenue base from income taxes to less distortive taxes such as recurrent taxes on immovable property or consumption.²⁵

Over the past 20 years, numerous states have increased their reliance on sales taxes.²⁶ Currently, 45 states and the District of Columbia apply sales taxes,²⁷ while 38 states also have local sales taxes.²⁸ Overall, sales taxes represented 32% of state tax collections and 13% of local tax collections.²⁹

In addition to “sales tax,” other forms of taxation are also applied at the point of sale. Most notably, excise tax is applied to certain items, such as alcohol, tobacco, and gasoline. In some cases, these taxes may be intended to discourage certain behaviors, such as smoking or drinking.³⁰ In other cases, they are intended to cover the costs that given activity imposes on the government; the gas tax, for example, is intended to pay for road construction and maintenance. Moreover, in some cases, the federal government may also levy excise taxes.

Other goods may be eligible for discounts on, or exemptions from, sales tax. These discounts and exemptions are typically intended to reduce the cost of necessities (though, in many cases, they are nonetheless regressive).³¹ For example, as of April 2022, 32 states and the District of Columbia did not charge sales tax on groceries (but did have sales tax on other items), while a further six states charged lower rates for groceries.³² Meanwhile, as of January 2020, 24 states and the District of Columbia taxed candy and/or soda at a different rate than other groceries (Figure 4).

One consequence of these excise taxes (state and federal), discounts, exemptions, and local sales taxes is that they complicate calculations of the amount of tax to be remitted and to whom.

²⁵ Åsa Johansson, Christopher Heady, Jens Matthias Arnold, Bert Brys, & Laura Vartiai, *Taxation and Economic Growth*, OECD Economics Department Working Papers No. 620 (2008), <https://doi.org/10.1787/241216205486>.

²⁶ Joe Eleniewski, Doug Nagode, & James P. Trebby, *Trends in State Taxation: Consumption Tax Versus Income Tax*, DELOITTE (2014), available at <https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-current-trends-in-state-taxation-consumption-tax-versus-income-tax-010915.pdf>.

²⁷ Jared Walczak, *State and Local Sales Tax Rates, 2024*, TAX FOUND. (Feb. 6, 2024), <https://taxfoundation.org/data/all/state/2024-sales-taxes>.

²⁸ *Id.*

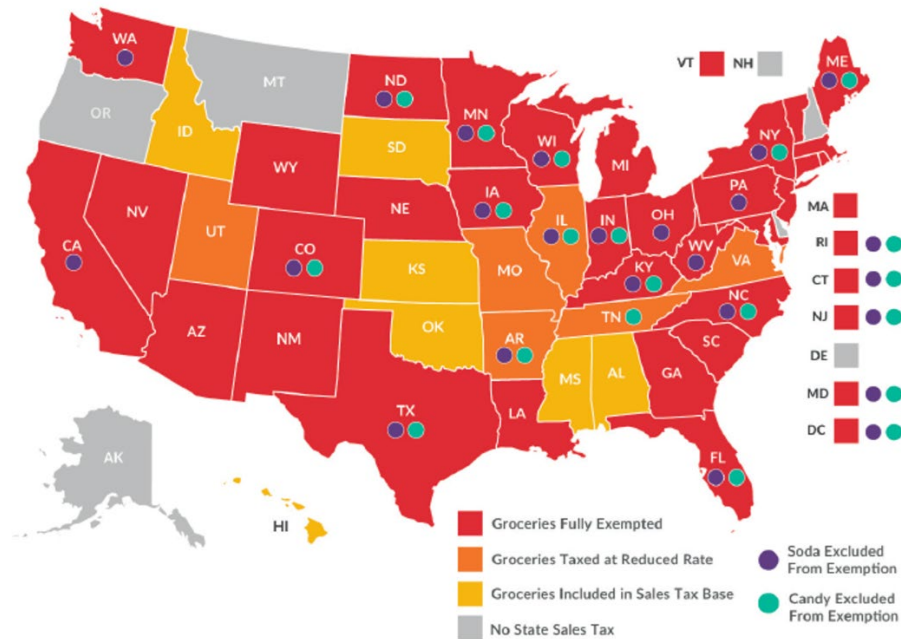
²⁹ *Id.*

³⁰ Randy W. Elder et al., *The Effectiveness of Tax Policy Interventions for Reducing Excessive Alcohol Consumption and Related Harms*, 38(2) AM. J. PREV. MED. 217–229 (Feb. 2010), <https://www.ncbi.nlm.nih.gov/pmc/articles/PMC3735171>.

³¹ Jared Walczak, *The Surprising Regressivity of Grocery Tax Exemptions*, TAX FOUND. (Apr. 13, 2022), <https://taxfoundation.org/research/all/state/sales-tax-grocery-tax-exemptions>.

³² *Id.*

FIGURE 4: Sales-Tax Exemptions & Reduced Rates for Groceries, Plus Exclusions from Exemptions for Soda & Candy



SOURCE: TAX FOUNDATION

A. Efficiency Considerations for Tax Collection at Point of Sale

All tax collection entails both compliance costs for taxpayers and administration costs for government. From an economic perspective, the challenge is to raise the desired tax revenue while minimizing the sum of these costs. As Kyle Logue and Joel Slemrod note:

an optimal tax remittance regime requires that tax liabilities be assigned so as to minimize the overall social costs of compliance and administration, for a given level of achievement of the tax law's desired distributional and revenue goals. By compliance costs we mean the private costs to the parties (and therefore the social costs) of complying with the law. By administrative costs, we mean the non-private social costs of enforcing compliance with the law.³³

With respect to taxes at the point of sale (including sales and excise taxes), merchants are generally in the best position to calculate how much tax is owed and to whom, since they know what they are selling, how much charge, and where they are physically located. It would be practically infeasible to implement taxes at the point of sale without the cooperation of—and reporting by—merchants.

³³ Kyle D. Logue & Joel Slemrod, *Of Coase, Calabresi, and Optimal Tax Liability*, 63(4) TAX L. REV. 797-866. (2009).

Until recently, most merchants kept paper records of transactions and used these to calculate how much tax is owed to which government. Such paper records are, however, time-consuming and expensive to maintain, and are also prone to both error and fraud.

In the past few decades, merchants have increasingly switched to using electronic transaction records, which in the case of retailers are often integrated directly with checkout systems; those checkout systems, in turn, are integrated with inventory systems.³⁴ By integrating tax reporting, such systems can reduce merchants' tax-compliance costs.

Regardless which system is used to record transactions, merchants always have incentives to miscode transactions and thereby reduce the amount of tax they must remit. But merchants' incentive to miscode transactions is reduced significantly when payments are made electronically, because state authorities can easily check their records against acquiring bank records and thereby identify any discrepancies.³⁵

In other words, from the perspective of economic efficiency, the combination of electronic payments and electronic reporting likely minimizes the combined costs of merchant compliance and government administration. Perhaps in part reflecting this, several state governments offer tax rebates or discounts to encourage electronic sales-tax reporting.³⁶

Arguably, governments could go further to offer incentives not only for electronic reporting but also for electronic payments, and thereby discourage the fraud associated with cash payments. This could be done, for example, by rebating some or all of the transaction costs that merchants incur related to point-of-sale taxes when payments are made electronically.

B. Equity Considerations for Tax Collection at Point of Sale

While there are strong economic arguments for the collection of taxes at the point of sale, there are clearly implications for merchants, who effectively become the tax collectors and incur the costs associated with the calculation, collection, recording, and remittance of such taxes. As such, in addition to the efficiency arguments discussed above, there may be equity reasons for reimbursing these costs.

³⁴ *Retail and Point-of-Sale Systems*, IBM, <https://www.ibm.com/history/point-of-sale> (last accessed Nov. 13, 2024).

³⁵ States typically have authority to subpoena records of the merchant and their bank when there is *prima facie* evidence of tax fraud. Such subpoenas—e.g., the merchant's own records—might in some cases be issued directly by tax authorities, while others could be issued only by a judge.

³⁶ See *Sales Tax Rebates by State*, DAVO BY AVALARA, <https://www.davosalestax.com/sales-tax-rebates-by-states> (last accessed Nov. 14, 2024).

It should be noted, however, that sales taxes are not the only taxes that businesses collect on behalf of government. Most businesses also collect and remit payroll taxes, for example. So, if there is an equity argument for reimbursing the costs of collecting and remitting sales tax, then conceivably there is also an equity argument to reimburse the costs of collecting and remitting payroll taxes.

III. Mandatory Interchange-Fee Exclusions: Why, What, and How?

This section outlines in broad terms why, what, and how certain components of a transaction would be excluded from interchange.

A. Why: Arguments Proponents Use to Justify Limiting Interchange Fees on Sales Taxes (and Other Items)

Proponents of excluding interchange fees from sales tax (and other items) argue primarily that merchants should not be responsible for the costs of collecting taxes. Moreover, they argue that the retention of interchange by issuing banks imposes an unfair burden on merchants.

To the extent that such “fairness” arguments are considered valid, it is not obvious that excluding interchange fees from taxes on point-of-sale transactions is the fairest or most effective method to redress the alleged iniquity. Meanwhile, extending the rebate to other items—such as gratuities—stretches the logic beyond its breaking point.

Twenty-five states currently permit merchants to obtain a rebate or deduction on some portion of the costs they incur for collecting sales taxes.³⁷ These rebates are usually intended to encourage timely reporting in a format that reduces the costs of monitoring and enforcing collection by the state. Moreover, many such programs cap the amount that can be deducted or rebated; as such, they are relatively more beneficial to smaller merchants—which, from an equity perspective, makes sense, as smaller merchants have proportionally higher fixed costs of compliance. The following are a few examples:

- Illinois currently permits merchants a discount of \$5 or 1.75% of the sales tax paid each year, whichever is greater.³⁸
- Florida permits merchants who file and pay electronically to deduct 2.5% of the sales tax remitted on the first \$1,200 due (up to a maximum of \$30).³⁹

³⁷ *Id.*

³⁸ See Ill. Gen. Assemb., 35 ILCS 120/3, Retailers’ Occupation Tax Act (2024), <https://www.ilga.gov/legislation/ilcs/ilcs3.asp?ActID=582&ChapterID=8>.

³⁹ See *Florida Sales and Use Tax*, FLA. DEPT. OF REVENUE, https://floridarevenue.com/taxes/taxesfees/Pages/sales_tax.aspx#:~:text=When%20you%20electronically%20file%20your, due%2C%20not%20to%20exceed%20%2430 (last accessed Nov. 4, 2024).

- Georgia permits merchants who file electronically to deduct 3% of the first \$3,000 due and 0.5% on the remainder.⁴⁰
- Pennsylvania permits merchants to deduct the lesser of \$25 or 1% of the tax collected for monthly filers; the lesser of \$75 or 1% for quarterly filers; and the lesser of \$150 or 1% for semiannual filers.⁴¹

A recent budget measure in Illinois, however, would cap merchants' annual discount at \$1,000 per-merchant.⁴² The Illinois Policy Institute estimates that this will cost retailers \$186 million annually.⁴³ This highlights one clear motivation for Illinois: to transfer liability for the costs of collecting tax from the state to issuing banks.

B. What: Policies that Limit the Retention of Interchange Fees on Sales Taxes and Other Items

Over the past two decades, more than 30 bills have been proposed in state legislatures that would have excluded the retention of interchange by issuers on sales tax and, in some cases, other items. Typically, the bills would have given merchants the right to deductions or rebates of interchange fees if they either notified the issuer at the time of the transaction, or if they requested a rebate subsequently.

To date, however, the only legislation limiting the retention of interchange fees on part of a transaction is Illinois' recently passed (and not yet implemented) IFPA. As such, it is worth considering that legislation, in particular. Despite its title, the IFPA does not actually "prohibit" interchange fees, *per se*. Rather, it states that:

An issuer, a payment card network, an acquirer bank, or a processor may not receive or charge a merchant any interchange fee on the tax amount or gratuity of an electronic payment transaction if the merchant informs the acquirer bank or its designee of the tax or gratuity amount as part of the authorization or settlement process for the electronic payment transaction.⁴⁴

Specifically:

⁴⁰ Enzo Garza, *Georgia 2023 Sales Tax Guide*, ACCT. PROSE (May 7, 2023), <https://blog.accountingprose.com/georgia-sales-tax-guide#:~:text=Yes.,pay%20their%20sales%20tax%20electronically.>

⁴¹ *Sales Tax File Upload Specifications*, PA. DEP'T. OF REVENUE, <https://www.pa.gov/en/agencies/revenue/resources/mypath/multi-import/file-upload-specifications/sales-tax-file-upload-specs.html> (last accessed Nov. 4, 2024).

⁴² See Bryce Hill, *Illinois General Assembly Oks \$1.1B in Tax Hikes for Record \$53.18B Spending*, ILL. POL. INST. (May 29, 2024), <https://www.illinoispolicy.org/illinois-general-assembly-oks-1-1b-in-tax-hikes-for-record-53-1b-spending>.

⁴³ *Id.*

⁴⁴ Interchange Fee Prohibition Act § 150-10 (a), *supra* note 18.

The merchant must transmit the tax or gratuity amount data as part of the authorization or settlement process to avoid being charged interchange fees on the tax or gratuity amount of an electronic payment transaction.⁴⁵

Alternatively, merchants:

... may submit tax documentation for the electronic payment transaction to the acquirer bank or its designee no later than 180 days after the date of the electronic payment transaction, and, within 30 days after the merchant submits the necessary tax documentation, the issuer must credit to the merchant the amount of interchange fees charged on the tax or gratuity amount of the electronic payment transaction.⁴⁶

In other words, under the IFPA, it is the merchant who determines whether interchange fees on taxes and gratuities charged at the point of sale are excluded or later rebated.

The IFPA employs an expansive definition of "tax" as "any use and occupation tax or excise tax imposed by the State or a unit of local government in the State."⁴⁷ Meanwhile, it defines gratuity as "a voluntary monetary contribution to an employee from a guest, patron, or customer in connection with services rendered."⁴⁸

C. How: The Mechanics of Excluding Sales Taxes from Interchange Fees

There are several ways that sales taxes (and other fees, such as service charges) might be excluded from interchange. As noted, the IFPA offers two broad alternatives: merchants would either transmit the tax and gratuity information for each transaction separately while the transaction is in process (option (a)), or they would transmit that information to their acquiring bank within 180 days of the transaction and the bank would seek recovery of the amount from the issuing bank (option (b)).

In practice, option (a) could be achieved either through "dual authorization," or through the use of "Level 2 & 3 messages," both of which would entail some reprogramming of POS machines, as well as changes to the messaging systems. Rebates, meanwhile, would have other undesirable consequences. This subsection describes each of these methods.

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ Interchange Fee Prohibition Act § 150/150-5, *supra* note 18.

⁴⁸ *Id.*

Before getting into the specifics, however, it is important to understand how payment transactions work. We therefore begin with a brief overview of the two types of payment transaction: single-message (“PIN”) transactions and dual-message (signature) transactions.

1. Single-message (‘PIN’ debit) v dual-message (signature) transactions

Single-message transactions are run over ATM/debit networks and generally rely on the personal identification number (PIN) programmed on the card to authenticate a transaction. As a result, only one message is required: a notification instructing the issuing bank to debit the account of the cardholder in the amount they have authorized and to credit that amount to the account of the merchant, less the discount fee, which is paid to the acquiring bank.

Because of the nature of the transaction, settlement can be effected over banks’ electronic-funds-transfer (EFT) networks, which were initially built to settle transactions at shared ATMs and, subsequently, over networks of ATMs.⁴⁹ As with an ATM transaction, single-message debit transactions clear more or less immediately, though settlement (debiting the cardholder’s account and crediting the merchant’s account) can take up to 24 hours.

In a dual-message (“signature”) payment transaction, the first message is a request for authorization. This message is sent to the issuing bank, which confirms the authenticity of the card and checks whether the cardholder has sufficient credit remaining (for a credit transaction) or funds in their account (for a debit transaction). But the message is also parsed by the network, which is able to monitor for fraud. If authorized, the second message contains information confirming the actual amount of the transaction, which is then either added to the cardholders’ credit-card bill or debited from the cardholder’s account during clearing and settlement, as appropriate.

The dual-message settlement process involves a delay in posting and clearing transactions, which has certain advantages. For example, if a customer presents a card at a sit-down restaurant, the check total would be sent for authorization by the card issuer and a hold placed on the account for the stated amount on the bill. If the customer then adds a tip to the bill, it can be included in the second message that authorizes payment of the full amount. Similar “holds” are also often used by online merchants to delay payment (sometimes by as much as several days), thereby reducing the likelihood of fraud and associated chargebacks.⁵⁰

⁴⁹ Stan J. Sienkiewicz, *The Evolution of EFT Networks from ATMs to New On-Line Debit Payment Products*, FED. RES. BANK OF PHILA. (Sep. 18, 2006), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=927473.

⁵⁰ See Mike Cannon, *Credit Card Authorization Hold: How and When to Use*, CHARGEBACK GURUS (Dec. 26, 2021), <https://www.chargebackgurus.com/blog/credit-card-authorization-holds>.

2. *Dual authorization*

In some respects, the simplest way to separate transactions for which interchange may be withheld from those for which it is prohibited would be for merchants to run two separate transactions: one for the main item, on which interchange would be withheld by the issuer, and a second for the sales tax (and any other exempted items), on which no interchange would be withheld.

For dual authorization to work, merchants would have to update their POS machines' software to split the transaction and to code the portions separately, so that issuers do not retain the interchange fee on the second transaction. This would also entail a change in the formatting of messages sent from POS machines through the payment stack to issuers, albeit likely a much less significant change than the use of Level 2 & 3 messages (see below).

At a minimum, dual authorization would slow checkout speeds dramatically. Indeed, payment cards would suddenly go from being the fastest form of payment to the slowest, resulting in a negative throughput effect.

A second problem is that, on some occasions, one of the transactions—but not both—would not be authorized. To mitigate such effects, merchants might choose to run all transactions as dual-message, placing a hold on the first transaction until the second has been authorized. That way, if one of the transactions is not authorized, the entire payment can be voided and an alternative payment method requested.

3. *Level 2 & 3 data*

As the discussion in Subsection 1 indicates, payment-card transactions work by sending messages across networks that authorize specific actions relating to accounts held with various financial organizations. In most cases, these messages are relatively simple (*e.g.*, a debit-card message: Party A authorizes \$100 to be debited from Account X at Bank 1 and credited to Account Y held by Party B at Bank 2; a typical credit-card message, meanwhile, is: Party A authorizes \$100 of her line of credit at Bank 1 to be credited to Account Y held by Party B at Bank 2).

In practice, additional information is often included in the messages. For example, when transactions involve a party who is not physically present (known as “card not present” transactions), authorization typically requires additional identifiers (such as the address of the cardholder) to be transmitted for purposes of verification.

All the information described thus far is considered “Level 1” data, which typically contain essential information required to authorize a payment, including:

- **Cardholder Data:** PAN (Primary Account Number), card-expiration date.
- **Transaction Amount:** The total amount requested for authorization.

- **Merchant Data:** Basic merchant information, such as the identifier or name.
- **Authorization Request:** Whether the transaction should be approved or denied based on available funds or credit limits.

Most payment networks also permit additional information to be sent via “Level 2” and “Level 3” data. Level 2 data provide information typically used in business-to-businesses (B2B) corporate-card transactions, primarily to help businesses better track and manage their expenses. This can include:

- Invoice number.
- Sales tax.
- More detailed data about the merchant, such as location or merchant category code (MCC).
- Details regarding what the transaction was for (goods/services).

Level 3 data provide even more detailed information, also primarily for B2B corporate-card purchases, including:

- Line-item details (e.g., description, quantity, unit price, and total price).
- Freight or shipping costs.
- Any discounts applied to the transaction.
- Any other tax amounts that need to be itemized.
- Shipping or delivery information for physical goods.
- Enhanced merchant details, such as DUNS (Data Universal Numbering System) numbers.

In principle, Level 2 & 3 data could be used to communicate sales tax (a Level 2 item); other taxes, such as excise taxes; and other items, such as gratuities (both Level 3 items). This would, however, amount to a significant change in the way the messaging system functions. As such, it would entail considerable reprogramming by all parties in the payment stack (merchants, gateways, acquirers, other processors, networks, issuers). This would inevitably result in increased cost for those parties.

Smaller merchants with few business clients typically will not have POS machines designed to collect and transmit Level 2 & 3 data. Therefore, for such merchants to adopt this method of reporting would entail replacing existing POS machines with more expensive devices.

In addition, single-message (PIN) debit networks are generally not able to process Level 2 or 3 data. Adding this functionality to single-message debit networks would be an enormous undertaking. Moreover, by increasing the size and complexity of messages, it would slow the message-sending process. That might, in principle, be a worthwhile undertaking for a debit network that primarily operates in a state that has introduced prohibitions on the retention of interchange on certain items. But most single-message debit networks are regional or national in scope and it is unlikely to make economic sense for those networks to undertake such a significant change to their networks, especially if it caused the entire network to operate more slowly, creating frustrations for merchants and consumers.

4. *Rebates on past transactions.*

The third option is for merchants to maintain records of the various amounts excluded from interchange and then request a rebate from the issuer. While this may sound simple in principle, it would be fiendishly complicated in practice.

To reduce fraud, most card information transmitted to POS machines is converted into cryptograms.⁵¹ Thus, for the acquirer to be able to request the rebate on the merchant's behalf would require both the merchant and acquirer to retain records of the cryptogram issued by the card, along with details of the amounts eligible for a rebate (in the case of the IFPA, all taxes collected at the point of sale and any gratuities). This would entail reprogramming POS machines and changing how acquirers process and store information.

The rebate is likely to be the only option available to merchants whose acquirer charges a blended MDR, as the rate they pay does not depend on the specific interchange fee charged in relation to any particular card. But at the same time, the fact that the merchant does not know the interchange fee charged for a particular card means that it won't easily be able to calculate the rebatable amounts. It would thus be forced to rely on either the acquirer or the issuer to calculate the interchange fee charged by correlating the stored cryptogram with the tax and gratuity data submitted by the merchant. The acquirer would then match this against the interchange fee applied in each case and calculate the rebatable amount.

The burden on both acquirers and issuers would be significant. Among other things, both acquirers and issuers would effectively be forced to create and maintain extensive correlated records of transactions and interchange fees charged over lengthy periods (at least seven months, in the case of the IFPA, and likely much longer, given the possibility of disputes).

To make matters worse, in the absence of appropriate surveillance, merchants would have incentives to abuse this system by claiming larger "gratuities" than were, in fact, contributed. Similarly, some merchants might expressly reduce their official prices and "encourage" customers to make large "voluntary" gratuity payments.

On top of plain fraud, there would inevitably be unintentional errors in recording transactions, which would result in under- or over-payment of rebates.

⁵¹ This is true for all contactless transactions, whether chips or mobile devices, as well as for all "dip" transactions in which the chip is inserted into the POS device. If the transaction data is not encrypted (e.g., if it is taken from a magstripe), then storage of the data would likely violate PCIDSS security protocols. A solution would therefore have to be found that takes unencrypted data and encrypts it in a way that ensures that it cannot be stolen, but can be correlated with the transaction data stored by acquirers and issuers. This might be possible by, e.g., using public-key infrastructure, but would entail essentially reinventing much of the architecture already developed by payment networks to establish secure transactions.

Issuing banks cannot know precisely what proportion of the interchange fee might later be rebated. Just from an accounting perspective, this would create headaches. But if a large proportion of merchants choose the rebate route, it would create a potentially significant contingent liability for issuing banks that might not be realized until six months or more after the transaction.

In the words of Glenn Grossman, “rebates applied to past transactions would be complex, expensive, and open to error and fraud.”⁵²

At a high level, all the possible mechanisms for excluding sales tax (and other items, such as gratuities) from the interchange fee would increase the complexity and cost of card payments, with various undesirable consequences for both merchants, consumers, acquirers, and issuers.

IV. The Effects of Excluding Interchange Fees from POS Taxes (and Other Items)

This section outlines the likely broad effects of excluding interchange fees from POS taxes and other items.

A. Effect on Mode of Payment

The introduction of exclusions on the retention of interchange fees by card issuers in relation to tax and other items is likely to result in various changes to the payment methods used by consumers. But these effects will vary depending on the means by which the exclusions are implemented.

1. Dual authorization

Merchants that implement dual authorization will likely see:

- An increase in use of three-party cards (American Express, Discover). These cards do not charge interchange fees, and thus won't be subject to the exclusions. As such, consumers will prefer them because they will be faster and less prone to fail.
- A shift away from card payments to cash, as some customers who lack a three-party card will once again see cash as a faster and more reliable option, especially for small to medium-sized payments.

2. Level 2 & 3 data

Merchants that use Level 2 & 3 data will likely see somewhat similar effects, although they will be more muted. If dual authorization is widespread, however, consumers may not be able to distinguish which merchants have adopted that method. Its effects could therefore become generalized, leading to a significant shift toward three-party cards and cash.

⁵² Grossman, *supra* note 17.

3. Rebates

The rebate method requires merchants to record transaction data. Depending which method is used, this could slow transactions considerably. Here, it is worth noting the IFPA’s definition of “tax documentation,” which is the term used for information that would be shared by merchants with acquirers to determine the rebate owed:

“Tax documentation” means documentation sufficient for the payment card network to determine the total amount of the electronic payment transaction and the tax or gratuity amount of the transaction. Tax documentation may be related to a single electronic payment transaction or multiple electronic payment transactions aggregated over a period of time. Examples of tax documentation include, but are not limited to, invoices, receipts, journals, ledgers, and tax returns filed with the Department of Revenue or local taxing authorities.⁵³

It is difficult to see how “multiple electronic transactions aggregated over a period of time” could be accurately correlated with the specific interchange fees charged. The same is true of “tax returns filed with the Department of Revenue.” Indeed, to the extent that the IFPA legitimizes the use of such data—or other means, such as invoices, receipts, journals, and ledgers not directly linked to individual transaction data—it implicitly invites fraud on a massive scale.

B. Effects on Merchants

While the implementation of the IFPA and similar legislation may ostensibly be intended to benefit merchants, in reality, its effects will vary significantly depending on the type of merchant and how the legislation is implemented. In general, as the following discussion documents, large merchants will benefit relative to small merchants.

1. Dual authorization

Merchants that choose to implement dual authorization will likely see:

- A slowdown in the checkout process due to an increase in “tender time” (*i.e.*, the amount of time it takes to take payment), reducing throughput. This will particularly harm high-throughput merchants, such as quick-serve restaurants.
- By slowing the shift to payment cards (including, in some cases, encouraging an increase in the use of cash), merchants will likely see a reduction in spending.
- By switching from single- to dual-message authorization, merchants could see an increase in interchange costs for debit.

⁵³ Interchange Fee Prohibition Act § 150-10 (a), *supra* note 18.

In many cases, especially for smaller merchants, these negative effects will outweigh any reduction in interchange fees.

2. *Level 2 & 3 messages*

Merchants who implement Level 2 & 3 data will likely need to invest in upgrades to the software in their POS machines—and, in many cases, to the hardware as well. Larger merchants will be at a competitive advantage, because they will typically already have advanced POS machines and will also be able to spread the cost of software upgrades across all their stores (though some of the programming may be specific to particular localities).

3. *Rebates*

Merchants who implement rebates on interchange fees *should* be required to develop secure means to store transaction, tax, and (as appropriate) gratuity data. This would enable them subsequently to submit requests to their acquirer in a manner that enables that acquirer and the cardholder's issuer to match a request to a specific transaction and associated interchange fee without compromising card or personal information. This would entail developing and implementing new systems. If such systems are integrated with POS machines, they could possibly be operated without significantly increasing tender time.

4. *Potential for gratuitous abuse*

The IFPA expressly forbids issuers from retaining interchange fees not only on sales tax, but also on gratuities—where “gratuity” means “a voluntary monetary contribution to an employee from a guest, patron, or customer in connection with services rendered.” While merchants would need to be careful to ensure that any “gratuity” is “voluntary,” many will surely restructure their prices so that gratuities become a larger proportion of the total amount charged.

Ironically, Illinois recently passed the “Junk Fee Ban Act,” which would, among other things, make it illegal to “offer, display, or advertise an amount a consumer may pay for merchandise without clearly and conspicuously disclosing the total price,” as well as to “misrepresent the nature and purpose of any amount a consumer may pay.”⁵⁴

5. *Broader effects on merchants*

As noted in Section 1, when the effect on sales are taken into consideration, the cost of card payments is less than the cost of cash for nearly all merchants. Some of the methods (dual authorization,

⁵⁴ Ill. Gen. Assemb., *Bill Status of HB4629*, 103rd General Assembly, <https://www.ilga.gov/legislation/billstatus.asp?DocNum=4629&GAID=17&GA=103&DocTypeID=HB&LegID=152072&SessionID=112> (last accessed Nov 4, 2024).

in particular) proposed to implement the exclusion of interchange fees related to POS taxes would increase the cost of card transactions for both merchant and consumer. This would lead to a reduction in the use of four-party cards. To the extent that this leads to a shift back to cash, or at least a slowing of the transition to electronic payments, it will almost certainly be harmful for merchants, as consumer spending will fall.

While some large merchants may benefit at the expense of smaller merchants, this would be a state-specific effect. The introduction of state-level interchange-fee regulations would mean having to develop and deploy state-specific processes and protocols in order to avail of the interchange-fee exclusions in those states.⁵⁵ As such, large merchants with a presence in many states would have to choose between continuing to use an integrated and uniform set of processes and protocols, or availing of the interchange exclusions in the state(s) where these apply.

C. Effects on Consumers

Proponents of interchange-fee exclusions for tax (and other items) argue that merchants will pass on savings to consumers. The experience with other interchange-fee regulations, including the Durbin amendment's price controls, suggests, however, that any such passthrough is likely to be minimal, at best.⁵⁶ Indeed, since most merchants will see little (if any) reduction in total costs, and some are likely to see costs rise, it is simply implausible that most merchants will reduce the amount consumers are charged for goods and services.

In addition, some merchants might encourage buyers to use account-to-account payments, such as Zelle, which are not subject to interchange fees but that offer little protection to consumers (in contrast to credit cards, which offer fraud detection and protection, as well as the ability to execute chargebacks).

D. Effects on and Response by Issuing Banks

In their agreements with consumers, credit-card issuers' terms include an array of specific commitments, ranging from ubiquitous ones related to fraud protection and zero liability, to more card-specific ones pertaining to things such as purchase-protection insurance and airline rewards. As already noted, the card companies meet those commitments, in large part, by retaining interchange fees on payments made using the cards. But if they are prevented from retaining interchange on some part of each transaction, this will reduce their revenue and hence their ability to meet the terms

⁵⁵ As Glenn Grossman notes: "These proposals would create a disjointed set of standards whereas today credit and debit card networks are interoperable at a global level, ensuring common standards regardless of location. These common standards allow a merchant to operate in multiple states with the processes and protocols to provide a reliable payment experience for all customers." See Grossman, *supra* note 17.

⁵⁶ Morris *et al.*, *supra* note 14.

of their agreements. In response, issuers will either adjust their terms or find alternative sources of revenue.

This response by banks is predictable, in part, because it is similar to their response to other interchange-fee regulations. The Durbin amendment is again instructive. The Federal Reserve imposed price controls on interchange fees retained by banks with assets of more than \$10 billion, causing those banks to lose billions of dollars in revenue each year. Covered banks sought to reduce their losses by increasing fees elsewhere. Specifically, they raised fees on checking accounts and increased the minimum deposit amounts required for free checking.⁵⁷ Many merchants saw little, if any, savings because of limited acquirer passthrough. In turn, merchants that did see their costs fall passed through little if any of those savings to consumers. Durbin instead primarily benefited big-box merchants at the expense of smaller merchants and, especially, lower-income consumers (many of whom were debanked).

From a consumer perspective, the cost of a product when purchased in a jurisdiction with sales taxes includes those taxes. Thus, consumers would reasonably expect any expenditure-related card benefits, such as rewards, to include the amounts they paid in taxes. But if there is no interchange fee on the tax portion (and possibly other items), the consumer will still pay the same total amounts, but the issuing bank will receive less interchange-fee revenue. Since national issuing banks are unlikely to change card terms for one or a few states, these costs will either be distributed across all cardholders, in the form of lower rewards and/or other card benefits, or issuers will work with payment-card networks to adjust interchange fees in order to recoup the costs from all merchants nationally, or some combination of these. In other words, states that prohibit the collection of interchange fees on taxes will create a significant negative externality for consumers and/or merchants in other states.

1. Differential effects on issuer revenue and response by issuing banks and credit unions

As noted, the exclusion of interchange fees on POS taxes and other items will result in a material reduction to issuer-bank revenue. These reductions will not, however, affect all issuers equally. One way that issuers may seek to compensate for the losses would be to encourage payment networks to increase multilateral interchange fees proportionally. But these interchange fees are set at a national, rather than state level. Moreover, as discussed in Section III, such adjustments would need to be set against the implications for merchant acceptance nationally, and therefore might not cover the full losses.

⁵⁷ *Id.*

If the payment networks adjust interchange fees so that the national net losses are minimal, banks and credit unions with only a local or regional presence would experience greater losses. It is perhaps not surprising that credit unions, in particular, are concerned about this legislation.⁵⁸

E. Effect on Government Revenue

As noted, the mandatory exclusion of POS taxes might lead to under-reporting of sales tax by merchants (especially if the sales-tax amount is automatically deducted). Perhaps more significantly, as noted above, by increasing the associated transaction costs, such mandates would discourage merchants from accepting four-party card payments. This would have several adverse consequences for government:

- First, to the extent that it reduces card payments generally, it would reduce throughput and ticket lift. In aggregate, this would reduce total sales, and thereby reduce POS taxes. Meanwhile, by reducing merchants' profits, as well as those of local suppliers, it would also reduce corporation taxes at both the state and federal level. And it would also likely result in a reduction in wages, thereby reducing income taxes.
- Second, to the extent that it results in a shift to cash payments or reduces the rate of transition to electronic payments, it would cause an effective increase in the administration costs of sales taxes relative to the baseline (since it is, as noted, easier to monitor and enforce sales taxes when there are electronic records of the transactions maintained by merchants and their acquirer banks).

In sum, state legislation prohibiting issuing banks from retaining interchange fees on POS taxes and other elements of a transaction might benefit some large merchants, but these benefits would come at the expense of smaller merchants, consumers, issuing banks (especially smaller banks and credit unions), and governments. Overall, such prohibitions would almost certainly create large net social costs.

V. Conclusions and Policy Recommendations

The foregoing analysis suggests that prohibiting issuing banks from retaining interchange fees on taxes and other elements of a transaction at the point of sale would create significant market distortions. Specifically, it would:

- harm small- and medium-sized merchants at the expense of large merchants;
- result in a net reduction in business activity and profitability;

⁵⁸ *Credit Union, Bank Legal Challenge to New Illinois Interchange Law Underway*, AMERICA'S CREDIT UNIONS, <https://www.americascreditunions.org/news-media/news/credit-union-bank-legal-challenge-new-illinois-interchange-law-underway> (last accessed Nov. 4, 2024).

- reduce the value of four-party payment cards to consumers, which would (and possibly reverse) the transition away from cash and toward electronic payments; and
- reduce revenue to issuing banks and credit unions, especially those whose business is primarily in the state(s) that implements such legislation.

For governments, it would increase the costs of administering sales tax and reduce not only the revenue the comes from sales tax, but also from corporation tax and income tax (in states that charge such taxes).

If states want to increase the net revenue they receive from sales taxes, while also ensuring that merchants are not unduly burdened by the costs of compliance, they might consider ways to reduce monitoring and enforcement costs.

For example, they could offer merchants incentives to use electronic payments and automated electronic reporting. As noted, some states already reimburse merchants for or permit them to deduct some of the cost of collecting and remitting taxes when those taxes are reported electronically. States might enhance compliance further by offering additional discounts or rebates in relation to transactions that are processed fully electronically (*e.g.*, card payments) and are hence more readily auditable.