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Credit card interchange fees—the charges that merchants effectively pay to card issuers for credit card acceptance—amount to an enormous transfer payment from the retail business community, primarily to the banking industry. In 2006, merchants paid more than $60 billion for credit and debit acceptance, an amount exceeding the entire worldwide venture capital investment budget or Hollywood box office receipts.[1] Fed up with the lack of competition on interchange fees, the merchants have resorted to the nuclear option, filing a massive antitrust class action against Visa and MasterCard as well as the large banks dominating the credit card industry.[2]

Assessing the arguments and analysis on the propriety of regulating interchange fees evokes the parable of the blind men touching the elephant.[3] Each commentator captures some partial truth, but in the end you are left feeling that together they can only argue about the nature of the whole. This article addresses six myths propagated about interchange fees by the card associations and leading antitrust academics and economists. Each purports to establish either that the current interchange-fee-setting system poses no competitive threat or, to the extent that it does, the problem could be solved with relatively minor tweaking. None of the six are persuasive. Ultimately, there is no shortcut. An assessment of the consumer welfare effects of interchange fees requires a careful economic analysis of fee levels and the full scope of merchant and card issuer competition.[4]

Myth One: History Confirms That Collectively Set Interchange Fees are Efficient

From early in their history, credit card systems imposed a fee that shifted revenue from merchants to card issuers. Commentators argue that this practice would have arisen at such an early stage only if issuers needed merchant-side revenue to support the issuance of a sufficient number of cards to make the system successful. Why else, they argue, would these nascent systems have adopted such a fee. They obviously had no market power and thus no incentive to impose an inefficient cost on merchants that would have hindered the development of the industry.[5]

But there is another explanation. The Visa and MasterCard systems were never structured exclusively as payment systems. Instead, they were designed from the outset as consumer lending programs that used a payment system to generate receivables. Beginning in the late 1960s, when the systems first developed, banks had little experience with revolving, unsecured consumer credit, particularly with an interest-free float period. Recognizing the need to issue large numbers of cards rapidly to convince merchants to participate, the banks could not ignore the real risk that they would suffer enormous losses if cardholders overwhelmingly paid off their balances during the float period before any interest had accrued.

Interchange fees may have originally functioned as a hedge against the risks attendant to an entirely new form of unsecured lending, ensuring a revenue stream to card-issuing banks as they came to terms with the potentially profitable but unsettling business of extending revolving credit with a grace period. Rather than being an essential component of an efficient payment card system, this alternative account casts interchange fees as something akin to the venture capital necessary to get the revolving, consumer credit system rolling.

If this alternative account is accurate, then the historical existence of interchange does not confirm its continuing benign nature. The hedge against risk would be justified only so long as the risk remained. The system, of course, has been rolling along pretty well for the last two decades. Payment card systems have been

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transformed from an untried business model to an immensely profitable one. The growth in card holding and transaction volume is well documented, and the largest issuers have maintained strong profitability; a fact confirmed by their continued aggressive pursuit of credit card customers with whom they have no other relationship.[6]

As technology has improved, transaction volume soared, and issuers earned substantial profits from interest and fee payments, one might have expected per transaction charges to fall and interchange to wither away. Predictably, non-interchange merchant fees have gone down. By contrast, from 1995-2005, interchange fees rose more than 25 percent.[7] One might contend that this increase is attributable to the banks lowering prices to cardholders. Anecdotally, credit worthy individuals observe a plethora of low-interest and reward-paying credit cards. System-wide, however, the notion that interchange fee increases have been completely offset by an increase in value for the cardholder is quite difficult to support. Cardholder costs actually increased through the year 2000, during periods when interchange fees also rose, and recent studies in other countries suggest that cardholder fees do not vary in anything approaching lock-step with interchange fees.[8]

Now that card-based lending has proven to be immensely profitable, the interchange fees that in the early days served as an essential hedge against risk might now be, by and large, an unnecessary anachronism that simply enables issuers to exercise market power over merchants. To be sure, interchange fees may serve a continuing important function. But the early history of the card systems pricing practices tells us nothing about what that function might be today.

Myth Two: The Courts Have Already Upheld Collectively Set Interchange Fees

Interchange-fee setting bears a marked resemblance to price fixing, that is, all Visa card issuers essentially agree to accept a fixed price from merchants. In the 1984 *Nabanco* case, however, the court refused to find the collectively set fees *per se* illegal. Following the Supreme Court's then-recent decision in *BMI*,[9] the court deemed cooperation essential to the competing banks' ability to produce a nationally accepted payment card.[10] At that time, regulations prevented individual banks from issuing cards throughout the country, and bank-by-bank interchange fees would have been impractical because the electronic-processing capabilities of the day were incapable of differentiating among the thousands of issuers at the point of sale.[11]

Applying the rule of reason, the *Nabanco* court found that credit card associations had no market power because there was no credit card market. Adopting the analysis of Visa expert, and former Assistant Attorney General of the Antitrust Division, Bill Baxter, the court found that all payment systems, including cash, checks, debit cards, ATM cards, store cards, gasoline cards, and travelers checks, competed. All payment methods were not interchangeable for all purposes, but for any given purchase, the court found, consumers could choose among several reasonable means of payment.[12] When the market is seen in this way, Visa held too small of a share to raise antitrust concerns.[13]

That conclusion was recently rejected by the Second Circuit in a government prosecution of Visa and MasterCard challenging system-wide rules that allowed banks to issue both Visa and MasterCard but no other brand. The trial court explained its reasoning through an analogy: Even though cars, trains, and buses provide substitute transportation for many destinations also served by airplanes, those alternatives would not be sufficiently close substitutes to stop commercial airlines from profitably raising prices if they were able to collude on airfares. The same reasoning applies to credit cards. In addition, the court found that both Visa and MasterCard, jointly and collectively, possessed market power based on both evidence of their market shares and their ability to raise price profitably without losing business.[14]

Although the government prosecution did not deal directly with interchange fees, the court considered them in deciding that the card systems had market power, noting that recent fee increases confirmed "'the defendant's power to control prices or exclude competition.'"[15] The court pointed to evidence that merchants "cannot refuse to accept Visa and MasterCard even in the face of significant price increases because the cards are such preferred payment methods that customers would choose not to shop at merchants who do not accept them."[16] Despite increasing their fees, neither Visa nor MasterCard lost "a single merchant customer as a result,"

and the networks discriminate among merchants as a monopolist would, charging higher interchange fees to those most dependent on credit cards.[17]

Although the *Nabanco* court's market analysis is almost surely outdated, it did not rest its decision on that ground alone. The court also found that procompetitive benefits flow from a collectively set interchange fee. First, establishing in advance the price that an acquirer must pay to an issuer allowed the systems to avoid the large transaction costs that would result if banks and merchants negotiated fees bi-laterally. Second, because a card issuer is the only buyer of the paper representing a cardholder's obligation to pay a charge, issuers could hold out and demand that acquirers pay fees that were anti-competitively high, leading acquirers to exit the system and merchant acceptance to drop.

Further, the court concluded that the interchange fee distributed the costs of the industry in a way that would provide proper incentives for banks to both issue cards and acquire merchants. Because of the fraud and credit risk borne by issuers, the court believed, card issuing had higher costs than merchant acquiring. "[B]y bringing the costs of the system in line with the revenue for each participating Visa member bank regardless of the role it plays," the court concluded that the collectively set interchange fee helped bring about ubiquitous merchant acceptance of credit cards.[18]

Unlike market definition, courts have yet to thoroughly analyze the competitive effects of collectively set interchange fees under current market conditions. But the early indications are that they will not accept *Nabanco*'s conclusions without careful scrutiny. The regulatory and technological restraints of the 1980s no longer exist, and card issuing and acquiring businesses now operate as independent profit centers. Many large banks now issue credit cards nationwide, and technology has also evolved to a point where merchants could feasibly differentiate issuers with different interchange fees at the point of sale. Card reading terminals now distinguish among multiple credit and debit card networks, as well as between reward cards and standard cards within a brand.[19] If a card reader can discern among types of Visa and MasterCard cards, then these readers could be programmed to distinguish among Visa and MasterCard issuers as well.

Although the recent government prosecution of Visa and MasterCard did not directly challenge the interchange fee, Judge Jones opined that, "[w]hile . . . it is very difficult to analyze the effects on consumer welfare of increases or decreases in interchange rates, merchants—and ultimately consumers—have an interest in the vigor of competition to ensure that interchange pricing points are established competitively."[20]

Indeed, one might argue that the fundamental rationale for refusing to condemn collectively set interchange fees *per se* no longer exists. American Express and Discover currently provide nationwide credit card systems with broad merchant acceptance, each setting its interchange fees independently. The notion that cooperation is necessary for the product to exist at all is now patently false.

Nevertheless, a potentially persuasive argument for continuing to permit collectively set interchange fees may still exist, namely the importance of small financial institutions participating in the credit card system. Although the largest Visa and MasterCard issuers could operate their own card systems, the thousands of smaller members of these systems could not. Although the retail banking market has consolidated substantially over the last decade, many small community banks, credit unions, and thrifts remain, particularly in smaller cities and rural areas. These small financial institutions issue cards to their customers and sign up their merchant clients to accept those cards. Some collaboration among banks remains necessary for these thousands of small institutions to remain part of the system. If one assumes procompetitive value to a payment system in which all banks can participate, it likely remains true that the collectively set interchange fee should not be *per se* illegal. Upon careful examination, however, the fees as currently formulated may violate the rule of reason.

Myth Three: Visa and MasterCard Have Lower Merchant Fees Than American Express, So They Must Be Reasonable

Commentators who point to American Express's higher merchant discount fee to justify Visa's and MasterCard's rates assume that payment cards are undifferentiated commodities.[21] In a commodified market in which no competitor has substantial market power, a higher merchant fee in equilibrium, as American Express's seems to be, could be explained only by the

fee's efficiency-enhancing tendencies. Otherwise, merchants would simply drop American Express in favor of other payment card systems that charge lower fees.

Payment systems, however, are not interchangeable, particularly from the merchant's perspective. Merchants pay American Express a higher merchant discount because it has convinced those merchants that AmEx cardholders are more valuable to them than the holders of other payment cards. A Ferrari costs more than a Mustang or a Camaro, but if Ford and Chevy collaborate, their prices will be anti-competitively high, albeit still lower than Ferrari's unilaterally set and hence lawful price. Ford and Chevy may lawfully exploit separately whatever market power is inherent in the Mustang or Camaro brand. But they must refrain from collaborating. Similarly, as a single entity setting its price to merchants unilaterally, American Express is free to exploit through supra-competitive pricing any market power that its brand provides. Citibank or Bank of America could do the same thing, but antitrust generally prohibits the two from enhancing their market power by collaborating on price.

Antitrust does not concern itself with supra-competitive unilateral pricing options because market forces guard against potential consumer harm. The existence of a monopoly rent incentivizes other firms to compete to capture it. This dynamic seems to operate as expected in at least some segments of the credit card market. Even in a segment such as restaurants, where American Express is prevalent, one can readily find establishments that do not take AmEx but do accept Visa and MasterCard. By exploiting its ability to charge higher prices to some merchants, American Express encourages competitive investment by other brands to close that quality gap. If Visa, for example, can convince merchants that it provides the same value as AmEx, the number of merchants who refuse to accept AmEx would increase, further stimulating competition among the brands. That the American Express fee is higher than the Visa/MasterCard fee thus reveals little about whether the latter is anti-competitively high.

A more enlightening comparison for evaluating the optimality of interchange fee levels would be between Visa and MasterCard, on the one hand, and the Discover Card system, on the other. Unlike American Express, but like Visa and MasterCard, virtually all Discover cards are revolving credit cards, and Discover does not have the sort of market power in its brand that would enable it to charge supra-competitive prices.

Curiously, commentators have virtually ignored Discover when making comparative claims about interchange fees. One exception is Stephen Bomse, who illustrates that the efficiency of revenue shifting from the merchant to the issuer is confirmed by Discover's no-fee, cash-back cards.[22] Although his point is sound in that Discover, like all networks, shifts revenue toward the cardholder, he goes too far in asserting that Discover "charge[s] cardholders nothing and offer[s] them a cashback bonus?"[23] Of course, Discover charges interest on balances and penalty fees for late payment and exceeding the credit limit. That interest and fee revenue has enabled Discover to become, and remain, a successful credit card issuer for more than two decades despite a merchant discount that is about 25 percent below Visa and MasterCard.[24]

Discover's success is a testament to the efficiency of a payment card system deriving revenue from interest and fee earnings and a relatively small merchant discount. Discover's success does not confirm that the Visa and MasterCard interchange fees are above optimal levels. Discover might have been even more successful had it charged a higher merchant discount. Nevertheless, Discover's survival for more than two decades confirms the possibility that existing interchange fees are too high.

Myth Four: Interchange Fees Are Based on Costs and Any Business Should Be Able to Cover Its Costs

Visa and MasterCard interchange fees do not merely enable card issuers to cover their costs, and in any event, cost-based interchange is extremely unlikely to be optimal. To be sure, Visa and MasterCard long contended that interchange fees were set according to a cost-based formula designed to enable issuers to recover the expenses incurred in providing credit cards to consumers. But this formula inexplicably failed to consider all of the revenue attributable to interest payments and a large portion of cardholder fee revenue. The networks sought to justify this exclusion by arguing that they were entitled to recover their costs separately for the two functions that credit cards serve: (1) as a payment system and (2) as a means of obtaining revolving credit. While issuers looked to cardholders to cover the cost of

the credit function, they claimed an entitlement to revenue from the merchants sufficient to ensure that they could cover the costs of the payment system function because, they believed, consumers would not pay issuers enough to use cards simply to transact.[25]

Consumers, of course, have shown that they are willing to pay dearly for revolving credit, and without a credit card payment system, the issuers' consumer-lending business would be impacted in a significant and negative way. Issuers would thus use cardholder fee and interest revenue as needed to ensure an efficient payment system, so long as they were earning sufficient profits overall to support their investment in the card business. In the United States, card issuing banks earn approximately 85 percent of their card-related revenue from interest payments (70 percent) and cardholder fees (15 percent).[26] The Visa and MasterCard so-called *cost-based* calculations are thus artificial constructs that try to mimic a payment card system that did not include a credit component. The formulas convey virtually nothing about the true relationship of interchange fees and overall issuer costs and revenue. Although more accounting information would be needed to draw a firm conclusion, issuers do not appear to need interchange fees, at least at current levels, to cover their costs. And even if they do, current costs may simply be wasteful efforts to compete for greater monopoly profits.[27]

In any event, regulating interchange fees by tying them to costs would almost certainly be a bad idea. Systems attempting to regulate price based on costs have historically been plagued with practical problems even in industries in which theory predicts that optimal prices should be set based on cost. The history of cost regulation is fraught with serious practical problems in large part because costs are too manipulable to serve as an objective means to regulate price.[28] In short, a firm has little incentive to cut expenses if its revenue is tied directly to its costs. There is little new to say about why regulatory schemes to set price based on costs have in practice worked so poorly. And given the lack of an established regulatory structure for credit card systems, one should not expect the practical problems with cost regulation to be any less in credit card markets.

More importantly with respect to interchange fees, an optimal price in the two-sided credit card market stands almost no chance of tracking costs even at the theoretical level. Generally, economic theory predicts that optimal prices will be a function of costs. In a two-sided market, however, economists have shown that, except by happenstance, the optimal interchange fee will be neither zero nor determinable by any strictly cost-based measure.[29] In credit card markets, services are sold to both cardholders and merchants and each side affects the other. Optimizing output requires issuers and acquirers to set prices in a way that will provide proper incentives for card use and acceptance. Balancing costs would achieve this result only if the elasticity of demand on both sides were equal, and setting the fee to zero would maximize output only if both costs and demand were equal.[30] Because neither is likely to be true, one should not expect either a cost-based or zero interchange fee. As a result, even if one could overcome the practical problems that have plagued virtually every prior cost-based regulatory scheme, the interchange fee flowing from any formula that looked exclusively to costs would likely be far from optimal.

Myth Five: As a Matter of Economics, Card Systems Have Incentives to Set Interchange at Optimal Levels as Long as Issuers Continue to Compete Intensely for Cardholders

Commentators have made two sorts of economic arguments attempting to justify collectively set interchange fees. The first rests on the general economic assumption that competition drives price to marginal cost plus normal profit. The second relies on the more sophisticated economics of two-sided markets. Neither compels the conclusion that card issuers have no incentive to charge merchants interchange fees that are anti-competitively high.

Advocates of the first approach contend that card issuing is so competitive that interchange revenue must be quickly competed away in the form of lower cardholder prices and higher rebates.[31] We only need to look in our mailbox to see evidence of this competition. As I was writing this piece, I received two offers on the same day that would provide me with more than $40,000 for balance transfers or cash advances at less than 3 percent interest, all fees included, for more than a year. Because issuers know that they will compete away any interchange fee revenue, this argument runs, card systems have appropriate incentives to keep interchange fees at optimal levels to maximize merchant

acceptance.[32] They will increase their fees only to the extent that higher fees would enhance the efficiency of the system. For example, if consumers required greater incentives to use cards at optimal levels and merchants would continue accepting them, card systems would increase interchange fees. They would not earn supra-competitive profits because they would compete away the increased revenue. But they would optimize system volume.

This version of the economic argument is flawed. Although layman and lawyers not versed in economics tend to see credit card solicitations and low rate introductory offers as evidence that the issuing market approaches perfect competition, economists recognize that issuers would not expend so many resources trying to attract cardholders if they were not earning substantial profits. Card issuing may be profitable for those banks that solicit heavily because of the differences among issuing banks. Larger issuers may be more efficient than smaller ones because of economies of scale. Moreover, Visa and MasterCard have cut special deals with many of the larger issuers, reducing their fees to levels below those of smaller issuers.[33] These factors may enable the large issuers to use interchange revenue to steal customers from smaller, less efficient issuers while still retaining substantial profits.

Although the large Visa and MasterCard issuers surely compete with each other as well as American Express and Discover, they might nonetheless be able to retain supra-competitive profits because of their ability to differentiate themselves through marketing, customer service, and rewards programs and thereby garner a measure of market power.[34] Excessive interchange may thus enable issuers to potentially retain supra-competitive profit from collectively-set interchange fees at the expense of merchants in competitive industries without the ability to retain excess profit.

The second, more sophisticated, economic argument contends that because credit card markets are two-sided, that is, they involve two separate customer sources whose use of the service directly affects each other, efficient pricing may require charging significantly above marginal cost to customers on one side of the market and significantly below marginal cost on the other in order to achieve efficient output levels. Just as newspapers efficiently charge readers much less than the marginal cost of producing and delivering the paper, a credit card system may efficiently provide cards to cardholders below marginal cost. If this is true, interchange fees may enable a payment system to attract sufficient cardholders to optimize output in the same way that advertising revenue enables newspapers to attract sufficient readership. Decreasing interchange fees and cardholder benefits to the point that consumers reduced card usage would not only reduce revenue from the transactional interchange fees that those merchants would have paid but also the loss of that volume may make cards less valuable to merchants causing them to leave the system and thereby further reduce card system revenue. In the extreme, as leading interchange fee economists David Evans and Richard Schmalensee point out, "the product [in a two-sided market] may not exist at all if the business does not get the price structure right."[35]

The economics of two-sided markets, however, can show only that the shifting of revenue from merchants to card issuers that is enabled by collectively set interchange fees *may* be efficient.[36] The possibility that card systems may use revenue-shifting to exploit market power remains. For example, the most recent economic models have shown that, if merchant demand elasticity is very low relative to cardholder demand elasticity, issuing banks with market power might profitably retain interchange fees as profit without significantly affecting merchant acceptance.[37] In the end, the economics does not answer the antitrust question, it merely channels the ways in which the law should seek to identify anticompetitive abuses.

An economically sophisticated court evaluating interchange flowing from merchants to issuers should therefore ask whether cardholder elasticity of demand is higher than merchant elasticity of demand, that is, would cardholder usage vary more with changes in the price of payment cards than merchant acceptance would vary with changes in the merchant discount. Demand elasticities can be difficult to measure. One can easily observe, however, that all existing payment card systems with a credit component, regardless of market share, charge a merchant discount higher than that necessary to support the acquiring side of the business. One can identify the revenue necessary to support acquiring by looking to the non-interchange fee portion of the Visa and MasterCard merchant discounts. This amount

is probably no more than .5 percent of the transaction amount. Given the generally accepted view that acquiring services are competitively priced, that American Express, Diners Club, and Discover all charge merchant discounts significantly above the .5 percent level indicates that they too shift revenue from the merchant to the issuing side. Moreover, increases in interchange fees have apparently had little affect on merchant acceptance, while card pricing decisions appear to affect cardholder usage dramatically. The direction of interchange fee payments therefore appears to be consistent with an efficient and competitive market.

The legitimacy of some interchange fee that shifts revenue from merchants to cardholders does not exclude the possibility that current interchange fees are set at inefficiently high levels. Interchange fees have increased significantly since the mid-1990s, while fraud costs have declined and interest rates have been at historical lows, limiting credit losses. All the while, issuer revenue has grown through increased transaction volume and receivables. All things being equal, lower costs and higher revenue on the issuer side should lead to lower interchange fees.[38]

Economic analysis does indicate that the need to stimulate card use through more risky extensions of credit and rewards programs could theoretically be efficient even in the face of declining issuer costs. To explain the increase in interchange fees beginning in the 1990s, however, one would need to identify some change in market conditions that created the need to shift an even higher percentage of revenue from merchants to issuers than had been shifted before.

All of the apparent changes, however, seem to point in the opposite direction. Assuming that the interchange fee was set at an efficient level at the beginning of the 1990s, there appears to be no efficiency enhancing change in the market that would justify the fee increases that have occurred over the past twelve years.

By contrast, there are reasons to believe that the increases in interchange fees arose as a result of the increasing level of market power that the largest card issuers obtained over merchants. Although Visa and MasterCard have dominated payment card volume since the 1970s, prior to the 1990s, the ability of the banks that control the systems to collectively harm consumer welfare was quite limited. Within the payment card systems, individual banks set virtually all of their own fees and competed with each other. Although the interchange fee was set collectively, the associations were open to any bank or other federally insured financial institution. Any potential for issuer market power would have been expected to spur entry or expansion by existing members, eroding supra-competitive profits and thus lessening any incentive for the banks to use their collective power over the interchange fee for anticompetitive purposes. In fact, in the late 1980s, large corporations whose main business did not involve banking did enter the payment card market on a large scale, most notably AT&T, General Motors, and General Electric.

Over the last decade, however, the largest card issuers have consolidated, increasing their dominance of the systems. Two decades ago, the 10 largest Visa and MasterCard issuers barely accounted for 40 percent of cards issued.[39] By contrast, today, the top five card issuers now control more than 80 percent of card transaction volume.[40] Executives from these large issuers, through their (1) representatives on the boards of directors of Visa and MasterCard and (2) general influence given their importance to the systems have effectively dictated the interchange fee. The associations have recently changed their corporate structures and are no longer controlled exclusively by banks. So long as the associations are operated to serve the interests of their member banks, however, the incentives governing interchange fee setting are unlikely to change. And because the few big issuers operate at a scale much larger, and have lower system costs, than the thousands of other issuers in the system, they likely have significantly more favorable cost structures that enable them to exploit excess interchange fee revenue in ways that smaller issuers cannot.

A second change has arisen on the card acceptance side of the market. Today, virtually all retail establishments accept credit cards, and many accept brands with relatively few cardholders. Most cardholders carry multiple cards from different systems and use their cards for constantly growing percentages of their purchases. As a result, banks have acquired a significant degree of market power vis-à-vis merchants. The point is not just that card transaction volume has increased as a percentage of all means of payment, but also that consumers

have come to expect ubiquity in card acceptance. Any merchant that decided to stop accepting Visa and/or MasterCard payment cards would likely face consumer backlash.[41]

Without the interchange fee, banks would have no way to exploit this power over merchants. Acquirers compete quite vigorously and their recent willingness to narrow their own margins in pursuit of volume suggests that they would quickly reduce merchant fees dramatically if interchange fees were abandoned. The largest card issuing banks may have more ability to control the means of competition with respect to cardholders because there are only a few large issuers. A critical empirical question is whether these large issuers have the ability to differentiate their products sufficiently to allow them to retain supra-competitive profits. The available information appears mixed. On the one hand, the issuers' ability to raise price is limited because consumers have grown accustomed to cards without annual or transaction-based fees and would likely respond to an increase in these fees by switching issuers. On the other hand, issuers have increased other less apparent fees, including late payment and over-the-credit-limit fees, and interest costs are often complex and hidden in ways that are hard for typical consumers to understand. For example, *no-interest* introductory periods for balance transfers and cash advances often require the payment of a fee, and payments are deducted from the *no-interest* balance first, meaning any charges made on the card will accrue interest unless the cardholder immediately pays off the balance transfer.

If merchants prove that interchange fees have been increased to benefit the issuing banks, they can likely demonstrate consumer harm. Economic analysis predicts that interchange fees will be set too high if banks pass on less interchange revenue to cardholders than they receive. The available evidence suggests that this is the case.

Myth Six: If There Is a Problem with Interchange Fees, the Simplest Solution Is to Permit Merchants to Surcharge Credit Card Transactions

Some commentators and regulators in other countries contend that surcharging card transactions would be a simple way to counteract, at least to some degree, any anticompetitive problems with interchange fees.[42] Although cash discounts are now permissible, most merchants charge uniform prices. Surcharging, however, may be a more powerful weapon because consumers respond more vigorously to an extra charge than to a discount. Australia and some European countries have thus overturned the card system rules against surcharging.[43]

This approach is facially attractive because it would be easy to implement, and by surcharging merchants would place the costs of card acceptance on the party generating the cost—the cardholder. If merchants were free to charge extra for using a particular card, the argument goes, then cardholders would internalize the interchange fees that their use of the card imposes on merchants and make card usage decisions accordingly. The card issuers would then risk losing transaction volume if cardholders switched to a different issuer or a different method of payment as a result of the surcharge, and issuers would thus have an incentive not to raise interchange fees above optimal levels.

This reasoning is suspect because two assumptions underlying it are controversial at best and probably false. The first is that the cardholder causes the merchant to incur the interchange fee, that the cardholder is, in a sense, at fault, and therefore in fairness the cardholder should bear this cost. But that is not uncontroversially true. As Ronald Coase demonstrated, in any two-party interaction imposing costs there is no natural cause because the cost would not result without the participation of both parties.[44] Either one or neither can be seen as causing the harm.

One can, of course, push the Coasian insight too far. The fist is indeed at fault, not the nose or jaw, in most face-punching scenarios. But Coase's causal insight is fully applicable to credit card transactions. Just as the charge would not accrue to the merchant if the cardholder did not use the card, the charge would not accrue if the merchant did not accept credit cards. The merchant accepts the card because it believes that card acceptance will expand its business. In that sense, the merchant is generating the cost to the same extent as the cardholder and in fairness should bear that cost as it does all of its other costs of doing business.

The second controversial assumption underlying the argument in favor of surcharging is that economically consumers should internalize the costs that they impose on a merchant. In a two-sided market like credit cards,

however, a seller maximizes output by discriminating between the two sets of customers based on costs and elasticities of demand. Forcing each customer to cover the marginal cost of the service that it receives could have ruinous results. Imagine, for example, that newspaper readers were required to cover the full cost of producing and delivering the paper. Readership would drop, advertisers would abandon print advertising, and newspapers as we know them might cease to exist.

Although the result in credit card markets might not be as extreme, the principle is the same. If merchants added a surcharge to card transactions, they would impose a cost on cardholders that would counteract the benefits that issuers provide to cardholders from interchange fee income. Surcharging would thus hinder issuers attempting to stimulate card use in circumstances where greater volume is needed to optimize the efficiency of the system. As economists Marius Schwartz and Daniel Vincent explain, a rule prohibiting surcharging alters the payment card system's "preferred structure of charges between merchants and cardholders. If merchant surcharges to consumers were unrestricted, only the [payment card system's] aggregate share would matter, its division between cardholders and merchants would be irrelevant." When surcharging is constrained, however, the payment card system can concentrate "its charges on merchants" and provide rebates to cardholders to induce card use.[45]

To better understand the problem with surcharging, consider a night club that offers free admission to women but charges men a cover charge. The club presumably adopts this policy to create an optimal mix of men and women in the club. If bartenders surcharged all drinks consumed by women to recover the amount of the foregone cover charge and women pay for their own drinks, the intended benefit of waiving the cover charge would be undone. Women who are unwilling to pay to get in would be unwilling to frequent the bar despite the free admission once they realized that the club would simply recapture revenue from them in another way.

More specific economic analysis suggests that no-surcharge rules under conditions that resemble those in credit card markets today may benefit consumers. Schwartz and Vincent undertook a rigorous analysis of the effects of surcharging on the quantities of purchases, assuming that merchants will accept and certain consumers will use cards irrespective of surcharging. They concluded that, in a market where card-issuing banks compete vigorously by offering rebates to card users, a rule prohibiting surcharges increases consumer welfare, though potentially at the expense of merchants.[46]

Some have suggested that the affect of a no-surcharge rule extends beyond merchants to non-credit card customers who pay what amounts to a tax in order to support customers using credit cards.[47] Even assuming that shifting revenue from merchants to issuers expands payment card system output and benefits cardholders, one can reasonably question whether consumers as a whole benefit when non-card users are forced to pay a portion of card costs. Moreover, even if prohibiting surcharges increased some utilitarian measure of total wealth, one might reasonably question whether such a system is fair on egalitarian grounds if the losers are disproportionately low income and minority consumers.[48]

This sad scenario, however, is riddled with problematic assumptions. First among them is that merchants in fact raise prices to non-card consumers because of their card acceptance costs. They might not. If credit card acceptance lowers merchant per-transactions costs, card acceptance could lead merchants in a competitive market to lower prices, benefiting cash as well as credit card customers. To know the direction of any subsidy among groups of consumers using different means of payment, one would need to know the relative cost of each form of payment. No form of payment is costless. For example, a merchant bears significant costs in accepting cash as a payment option, ranging from the costs of obtaining change and the time it takes to give it to the costs of counting the cash, making deposits, and insuring against the risk of theft. These costs do not directly benefit credit card customers, yet all consumers must contribute to the merchant's ability to cover its costs of accepting cash. Although credit cards appear to impose higher per-transaction out-of-pocket costs on merchants, the total cost of each form of payment for merchants in different business settings remains a controversial subject with no definitive answers.[49]

Even if one were certain that credit card acceptance increased a merchant's per-transaction costs, the prices that merchants charge might nonetheless be lower than they would be if the merchant did not accept cards. This outcome could occur if credit card use provides

customers with additional purchasing power or simply encourages them to spend more, enabling merchants to sell more goods and thus reduce overall prices. In addition, card use speeds up checkout lines, directly benefitting both card users and non-card users, through shorter wait times, and indirectly to the extent that faster throughput enables merchants to lower prices compared to what they would have been if the merchant did not accept cards at all. To be sure, these latter benefits could be obtained with pin-based debit cards that impose lower costs on merchants once the technology for acceptance is installed. But many customers will not use debit cards to the extent that they use credit cards because they (1) need, or prefer, the float period or revolving credit offered by credit cards; (2) value the security of maintaining their level of cash on hand in case an emergency expense arises for which they cannot use a credit card; and (3) fear that fraudulent use of their debit card would have more severe consequences than credit card fraud. With respect to this last factor, the most significant difference is that debit fraud can empty the cardholder's checking account, leaving her without access to her money for some indeterminable period of time. By contrast, credit card fraud does not raise that concern because a credit card issuer has no direct access to the cardholder's deposit accounts.

Even if merchants accept cards only for strategic reasons—that is because they believe that they must do so to avoid losing customers to competitive merchants—one still cannot be certain that accepting cards leads merchants to increase prices compared to what they would be if the merchant did not accept cards. To be sure, if a merchant accepts cards for strategic reasons, it may pay more to accept the card than the per-transaction benefit. But if failing to accept cards caused the merchant to lose significant sales volume, which of course is the fear that would lead the merchant to accept cards for strategic reasons, then a merchant who did not accept cards might have to charge more per unit of a good to cover its fixed costs as a result of the lower volume caused by its failure to accept cards. In sum, unless one were certain that accepting cards leads the merchant to charge more than it otherwise would, the direction of any *tax* is uncertain.

Moreover, even if payment card acceptance does lead a merchant to raise prices relative to what it would have charged if the merchant did not accept cards, merchant fees still would not necessarily constitute an unreasonable tax on non-card customers. To make that claim compelling, one would need to demonstrate that interchange fees are somehow different from all other merchant-provided amenities that benefit a particular sub-group of consumers but the costs of which are spread among all consumers. For example, when a merchant offers shopping carts that only certain customers use, the merchant bears the costs of purchasing and maintaining them as well as hiring laborers to gather them from the parking lot. Like credit card fees, these costs are blended into the cost of the merchant's goods and are thus born in part by shoppers who never use carts. One could thus argue that, because of uniform pricing, every sub-group of customer effectively imposes a portion of the merchant's cost of doing business on other groups of customers who do not benefit from that particular merchant expenditure. At its limit, one might argue that, because small purchases generally impose a greater cost on merchants than large ones, the wealthy who tend to make larger purchases effectively subsidize poorer consumers who make smaller purchases. The pervasiveness of the practice of ignoring these differences and blending costs counsels against the conclusion that it is generally unreasonable, and one suggesting that credit card fees should be treated differently bears the burden of explaining why they are different.

One commentator has suggested that excessive credit card fees are different because consumers can choose whether to use virtually all merchant-provided amenities, but consumers without a credit card cannot choose to use one if no bank will issue a card to them.[50] This attempt to distinguish card payments from other merchant provided amenities likely overreaches the mark. First, in many, perhaps most, cases consumers who do not use credit cards could use them but choose not to for a host of reasons, including philosophical objections, budget planning, avoiding interest, masking a record of the purchase, and whim. In these cases, then, credit card acceptance is no different from other merchant-provided amenities.

Second, although there is evidence that card use correlates with factors such as race and income,[51] this evidence does not show the percentage of all non-card-users in these groups who could not get a credit card. The problem for these groups may be a lack of information about the availability of credit cards or a

fear of using them. Educating non- and under-banked consumers about banking services could enable more low-income consumers to obtain the advantages of credit card use.

Third, the argument that some consumers have no choice in the matter begs the question as to what counts as a choice. Some of those who are unable to use credit cards are in that position not because of some immutable trait but simply because their prior choices with respect to credit have led them to max out their available limits and indicate that they cannot be trusted with additional credit. The particular choice at the moment of a purchase decision has no special claim to be privileged over earlier choices that may account for the individual's current inability to use a credit card.

Of course, there are some who through no fault of their own cannot choose to use a credit card—the children of extremely poor credit risks, for example. With respect to this group, however, credit card fees are not unique. Some consumers in the unable-to-get-a-credit-card category cannot benefit from other merchant provided amenities for essentially the same reasons. Parking, for example, is a significant and costly benefit that cannot be enjoyed by those without cars. The carless, like those without credit cards, come disproportionately from low income and minority groups.

In the end, it is quite difficult to make the case that surcharging must be permitted to right a social wrong inflicted on those who use other means of payment. And given the economics of two-sided markets, permitting surcharging is far from a riskless way to combat the anticompetitive effects of interchange fees.

Conclusion

The social welfare effects of credit card interchange fees are complex. There is no simple metric that can justify or condemn them. Rather, economic understanding must be brought to bear upon rigorous fact finding to determine whether government should in some fashion intervene in the interchange fee-setting process.

Notes

1. Adam J. Levitin, "Payment Wars: The Merchant-bank Struggle for Control of Payment Systems," 12 *Stan J. L. Bus. & Fin.* 425, 427 (2007).
2. In re Payment Card Interchange Fee and Merchant Discount Antitrust Litigation, 398 F. Supp. 2d 1356 (Jud. Pan. Multi. Lit. 2005) (consolidating cases for pre-trial discovery).
3. John Godfrey Saxe, "The Blindmen and the Elephant," *http://en.wikisource.org/wiki/The_Blindmen_and_the_Elephant* (last checked 3/11/2008).
4. *See generally,* Steven Semeraro, "Credit Card Interchange Fees: Three Decades of Antitrust Uncertainty," 14 *Geo. Mason L. Rev.* 941 (2007).
5. David S. Evans & Richard Schmalensee, Paying with Plastic: The Digital Revolution in Buying and Borrowing 153 (2d ed. 2005); Timothy J. Muris, "Payment Card Regulation and the (Mis) Application of the Economics of Two-Sided Markets," 2005 *Colum. Bus. L. Rev.* 515, 532; Richard A. Epstein, "The Regulation of Interchange Fees: Australian Fine-Tuning Gone Awry," 2005 *Colum. Bus. L. Rev.* 551, 585; William F. Baxter, "Bank Interchange of Transactional Paper: Legal and Economic Perspectives," 26 *J.L. & Econ.* 541, 574-582 (1983).
6. Evans & Schmalensee, *supra* n.5, at 3 (between 1986 and 2000, percentage of consumer expenditures in the US on payment cards grew from 3 percent to 25 percent); *id.* at 233 (noting exponential transaction volume increases from the early 1970s through the 1990s); *id.* at 215 (noting that less than 20 percent of credit cards are issued to consumers with whom the bank has a pre-existing relationship).
7. Although merchant discount rates fell from about 2.7 percent to 2.0 percent from 1982 through 1994, Evans & Schmalensee, *supra* n.5, at 126, by 2001 they had risen to 2.3 percent *id.* and have continued to rise. James M. Lyon, "The Interchange Fee debate: Issues and Economics," The Region, *http://www.minneapolisfed.org/pubs/region/06-06/interchange.cfm* (Jan. 19, 2006).
8. Evans & Schmalensee, *supra* n.5, at 235; European Commission, Competition DG, Financial Services (Banking and Insurance) Interim Report I Payment Cards: Sector Inquiry under Article 17 Regulation 1/2003 on retail banking 56 (Apr. 12, 2006).
9. Broadcast Music Inc. v. Columbia Broad. Sys. Inc. (BMI), 441 U.S. 1 (1979).
10. Nabanco v. Visa U.S.A.,779 F.2d 592 (11th Cir. 1986), *affirming,* 596 F. Supp. 1231, 1251-1254 (S.D. Fla. 1984); *see* Reyn's Pasta Bell, LLC v. Visa U.S.A., 259 F. Supp. 2d 992, 1000 (N.D. Cal. 2003) (similarly rejecting *per se* treatment); *see also* Worthen Bank & Trust Co. v. National BankAmericard Inc., 485 F.2d 119 (8th Cir. 1973) (holding that card system by-law prohibiting members of one system from joining another could not be determined to be a *per se* illegal group boycott on summary judgment and requiring a full trial at which rule-of-reason analysis could be appropriate).
11. Nabanco, 596 F. Supp. at 1254-1255.
12. *Id.* at 1257, 1259.
13. *Id.* at 1252, 1257-1258.
14. United States v. Visa U.S.A., 163 F. Supp. 2d 322, 335, 340-341 (S.D.N.Y. 2001), *aff'd,* 344 F.3d 229, 238-240 (2d Cir. 2003).
15. *Id.* at 340.
16. *Id.* at 399-400.

17. *Id*. at 341.
18. *Nabanco,* 596 F. Supp. at 1260-1261.
19. Evans & Schmalensee, *supra* n.5, at 259; Lyon, *supra* n.7.
20. Visa U.S.A., 163 F. Supp. 2d at 396.
21. Muris, *supra* n.5, at 542; Testimony of Joshua Peirez, Group Executive, Global Pulibc Policy & Associate General Counsel, MasterCard Worldwide, Before the US Seanate Committee on the Judiciary, Hearings on Credit Card Interchange Rates: Antitrust Concerns 7 (Jul. 19, 2006).
22. Stephen V. Bomse & Scott A. Westrich, 2005 *Colum. Bus. L. Rev.* 643, 653.
23. *Id*. at 665.
24. Visa U.S.A., 163 F. Supp. 2d at 333, 388-389; Evans & Schmalensee, *supra* n.5, at 13, 77-78, 214.
25. *Id*. at 150, 154-155.
26. *Id*. at 223.
27. Alan S. Frankel, "Monopoly and Competition in the Supply and Exchange of Money," 66 *Antitrust L.J.* 313, 342 (1998).
28. David A. Balto, "The Problem of Interchange Fees: Costs Without Benefits?," 2000 *Eur. Competition L. Rev.* 215, 219 (2003).
29. Richard Schmalensee, "Payment Systems and Interchange Fees," 50 *J. of Industrial Econ*. 103, 114 (2002).
30. *Id*. at 118-19; Julian Wright, "The Determinants of Optimal Interchange Fees in Payment Systems," *LII J. of Indus. Econ*. 1, 22 (2004).
31. For example, Tim Muris writes, "[i]f issuers receive less from merchants then they must receive more from consumers or reduce the benefits that consumers receive." Muris, *supra* n.5, at 543.
32. Jean-Charles Rochet & Jean Tirole, "Cooperation Among Competitors: Some Economics of Payment Card Associations," 33 *Rand J. Econ*. 549, 563 (2002).
33. Evans & Schmalensee, *supra* n.5, at 204.
34. *Id*. at 22
35. *Id*. at 4.
36. Dennis W. Carlton & Alan S. Frankel, Transaction Costs, Externalities and "Two-Sided Payment Markets," 2005 *Colum. Bus. L. Rev.* 617, 630.
37. Wright, *supra* note30, at 11-12; Zhu Wang, "Market Structure and Credit Card Pricing: What Drives Interchange?," 22-24 (Payments System Research, Federal Reserve Bank of Kansas City Working Paper 06-04 (Dec. 20, 2006)).
38. Evans & Schmalensee, *supra* n.5, at 154-155.
39. *Id*. at 203.
40. Lyon, *supra* n.7.
41. Visa U.S.A., 163 F. Supp. 2d at 340-341; Muris, *supra* n.10, at 522.
42. Adam J. Levitin, "Priceless?: The Competitive Costs of Credit Card Merchant Restraints," 55 *UCLA L. Rev.*—(forthcoming 2008); Frankel, *supra* n.28, at 347-349.
43. Adam J. Levitin, "The Antitrust Super Bowl, America's Payment Systems, No-Surcharging Rules, and Hidden Costs of Credit," 3 *Berkeley Bus. L.J.* 265, 283-285 (2005).
44. Ronald Coase, "The Problem of Social Cause," 3 J. Law & Econ.1, 14-15 (1960).
45. Marius Schwartz & Daniel R. Vincent, "Same Price, Cash or Card: Vertical Control by Payment Networks," 3 (Georgetown Univ. Dep't of Econ., Working Paper 02-01) (Feb. 2002); Rochet & Tirole, *supra* n.32, at 562 ("the card surcharge in stores raises the issuers' cost of providing cardholders with a given surplus of using the card and thus inhibits the diffusion of cards.").
46. Schwartz & Vincent, *supra* n.45, at 5-6.
47. Dennis W. Carlton & Alan S. Frankel, "The Antitrust Economics of Credit Card Networks," 63 *Antitrust L.J.* 643, 660-661 & n.40 (1994-1995); Statement of W. Stephen Cannon on Behalf of the Merchants Payments Coalition, Inc. Before the U.S. Senate Committee on the Judiciary Hearings on Credit Card Interchange Rates: Antitrust Issues? 4, 11(Jul. 19, 2006).
48. *Id*. at 638-640.
49. *See* Daniel D. Garcia Swartz, Robert W. Hahn & Anne Layne-Farrar, "The Economics of a Cashless Society: An Analysis of the Costs and Benefits of Payment Instruments (AEI-Brookings Joint Center for Regulatory Studies," Related Publication No. 04-24, (2004) (available at *http://www.aei-brookings.org/admin/authorpdfs/page.php?id=1048)* (A revised version was published in the Review of Network Economics June 2006). But *see* David Humphrey, *et al.*, "What Does It Cost to Make a Payment?," 2 *Rev. of Network Econ*. 159, 162-163 (2003).
50. Adam J. Levitin, "Priceless?: The Social Costs of Credit Card Merchant Restraints," 45 *Harv. J. on Leg.*—(Forthcoming 2008).
51. "Study Shows Card Use Linked to Race," Cardline, May 24, 2005, available at *http://www.cardline.com* (citing a study based on data from the Federal Reserve's Survey of Consumer Finances for the years 1992-2001).