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The U.S. (quietly) lets banks extract high credit card transaction fees. This raises prices for everyone and shifts $billions from poorer to wealthier Americans.

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There are many mechanisms through which the financial establishment systematically drains money from workers struggling to pay their bills. Some hum along in plain sight while regulators and members of Congress barely take notice. Such is the case with the $80 billion in fees[1] that banks will extract from credit and debit card transactions this year.

While other countries have lowered credit card transaction costs, either through non-bank market innovation (in China) or regulation (in the European Union, Australia, and other nations), U.S. policymakers empower banks and credit card networks to levy what amounts to a doubly regressive national sales tax. Credit and debit card payment fees extracted through oligopoly power have two main adverse impacts:

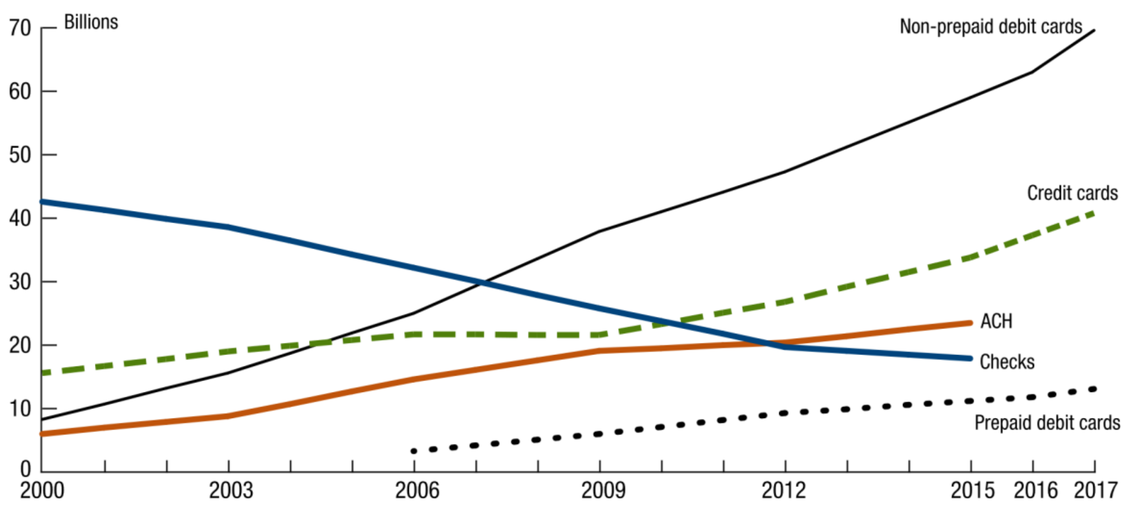
1) **Raising prices for all consumers including those paying with cash.** Because merchants typically charge the same price regardless of payment method, excess credit card fees are a dead weight across the economy, undercutting consumer buying power as well as merchant profits, and causing indirect economic harm such as job loss.

2) **Shifting billions of dollars each year to wealthier Americans** (who are most likely to use credit cards) **from the middle-income** (more likely to use debit cards with lower fees) and especially **from the lower- income** (most likely to use cash).

Regressive Effects

Ranging from roughly 1% to 5% of purchase price,[2] debit and credit card transaction fees shift money from poorer to wealthier people in two ways. Higher prices across the market hurt lower-income consumers the most because their spending is most likely to be for necessities rather than items they can forego. Yet far greater regressivity[3] results from rebates to card users in forms such as cash or airline points.[4] [5] For credit card holders, these rebates, in effect, reduce, or cancel out, the general price increase absorbed by other shoppers, particularly those paying in cash. Banks and affiliated credit networks compete for affluent customers by offering high-reward cards, which leads to yet higher transaction fees absorbed by all consumers and merchants, who have little bargaining power in refusing or altering bank/credit card contracts.[6] As shown in Figure 1 below, credit and debit card usage is ubiquitous and growing rapidly.[7] Though still very important, cash lost its position as the most used payment method last year.[8]

Figure 1 - Trends in noncash payments, by number, 2000-17



Card payments have been growing rapidly since 2000.

Source: Federal Reserve Payments Study - 2018 Annual Supplement

Studies done when Congress considered major changes to the card payment system a decade ago estimated that only 13 to 20 percent of bank interchange fees represent the actual cost to process transactions.[9] An analysis co-authored by former Commerce Department official Robert Shapiro determined that in 2008 about $27 billion of $48 billion in total interchange fees was passed along to consumers in higher prices. In 2019, following a decade of robust growth in credit and debit card use, similar assumptions would lead one to estimate that consumers are absorbing at least $45 billion in bank interchange costs (net of the cost of providing these services) passed along in higher prices. Much of this ends up in the pockets of higher-income groups: to credit card users in the form of rewards and to bank shareholders as profit.

Boston Federal Reserve Bank economists found that transaction fees and reward programs resulted in cash-using households paying on average $149 to credit card using households, while credit card using households received an average of $1,133 from cash users each year.[10] (The 2010 study defined cash as all payment instruments other than credit cards, including cash, checks, and debit and prepaid cards.) They concluded that 79 percent of bank revenues from credit card merchant fees was obtained indirectly from cash payers -- and disproportionately from lower-income cash payers. A similar analysis today likely would find that much larger regressive transfers, when taking into account the growing use of credit cards, higher rewards, and less use of cash over the past decade. The two studies were done just after concerns about credit card pricing competition had prompted Congress to pass legislation giving the Fed authority to regulate interchange fees associated with debit cards, but not credit cards. The Fed economists concluded that the large transfers they found -- 1.8 percent of median income across all households -- suggested a “complementary” reason for further policy changes: the growth of income inequality. Creating the opposite effect of compound interest, systemic transfer of 1.8 percent of median income each year from poorer to wealthier can open wide gaps between income groups over time.

As if to add insult to injury, U.S. tax law results in greater unfairness. In a 2019 report on emerging Chinese payment systems with much lower transaction fees, Aaron Klein of Brookings notes that, because U.S. tax law considers credit card rewards to be rebates rather than income, card holders receive them tax free. So, a high-income American getting 1.5 percent cash back on $80,000 of credit card purchases, in effect, enjoys the equivalent of $2,000 in added income, including about $800 in tax savings.[11]

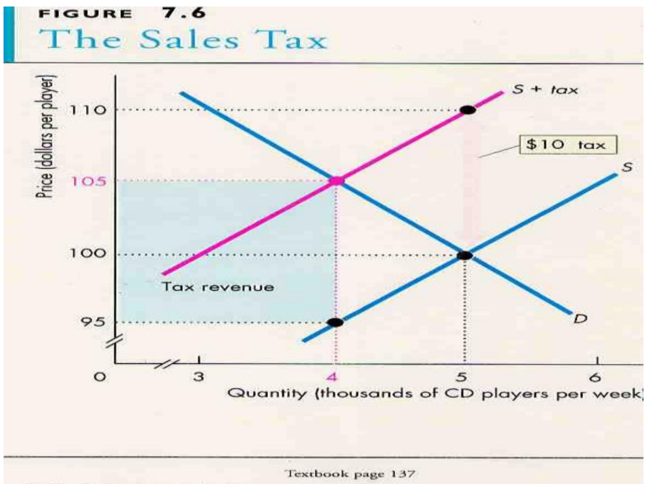
Looking the Other Way

The payment system now hums along much like oil rigs pumping in the background. U.S. lawmakers have spent almost a decade ignoring the flow of billions of dollars from the bottom to the top of the income heap. In 2009, the GAO reported that 30 countries had taken or were considering measures to reduce bank interchange fees and retail prices.[12] Proposals included (1) setting or limiting interchange fees, (2) requiring their disclosure to consumers, (3) prohibiting card networks from imposing rules on merchants that limit their ability to steer customers away from higher-cost cards, and (4) taking antitrust action. Shapiro and co-author Jiwon Vellucci found that U.S. credit and debit card arrangements do not allow the free market to set competitive prices, thereby forcing additional costs on merchants and consumers. They recommended that a federal agency should develop rules to determine appropriate fee levels, adding: "(at) a minimum, the Federal Reserve Board or the Federal Trade Commission should examine our credit-card system's fees and practices and recommend reforms to reduce the impact on consumers and jobs."

In 2015, the European Union capped interchange fees at 0.2% of the transaction value for Visa and Mastercard consumer debit cards and at 0.3% for consumer credit cards.[13] Much earlier, the Bank of Australia reduced the weighted average of interchange fees on major credit cards from .95 percent to .50 percent and merchants were allowed to add price surcharges reflecting the added cost of card transaction fees. A 2008 review found these reforms resulted in $1.1 billion in consumer savings the previous year (though opponents said they led to higher annual card fees and lower reward values).[14]

Better Uses for the Money

Broader questions of fairness arise from the fact that the U.S. government allows bank/credit card arrangements to extract $45 billion or more in excess fees and profits far larger than found in more competitive markets. If, instead, the U.S. were to impose a consumption tax gathering the same amount, it could direct the proceeds toward struggling workers rather than away from them. For example, $45 billion would allow the government to distribute $700 annually to every household earning less than $60,000 (the national median), either in cash or otherwise. The funds could be contributed to retirement savings accounts in a system which would allow all workers to profit from capital investment rather than paying unnecessary fees on top of what they consume.[15] Instead, Congress and the President continue letting banks to levy an informal tax -- a “value-subtracted tax”? – that diminishes consumer buying power and financial well-being with every transaction.



Dormant for a decade, issues concerning bank transaction fees, monopolistic power, and their negative impacts on lower-wage consumers have emerged once again. This time, the political impetus is not so much consumer protection as concern that new market entrants might reduce bank profits. In China, non-bank high tech payment systems using electronic wallets that operate through that country’s versions of Amazon (Alipay) and Facebook (WeChat Pay) have leapfrogged cash and bank card transactions.[16] Transaction fees embedded in these new systems are far lower than what U.S. banks charge.

Competition from systems such as these could eventually drive down U.S. bank interchange fees.[17] Alternatively, instead of lowering prices through competition, new players in the U.S., or those in China for that matter, could eventually learn to use monopoly power to raise fee levels.[18] This is entirely possible in China where the people running high-tech systems are probably more intertwined with the ruling Communist Party than the bank and credit network lobbies are with U.S. lawmakers.

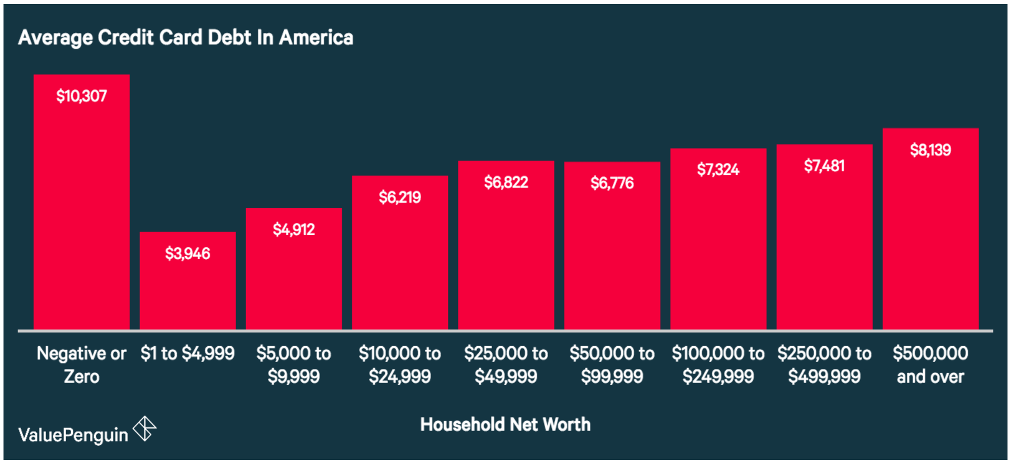
As Facebook[19] fends off accusations that its payment system could compromise consumer privacy, one cannot help but notice that U.S. banks have been selling aggregate data gleaned from card payment transactions to hedge funds for many years.[20] Beware the smoke, mirrors and theatrics as the lobbyists swarm Capitol Hill. High bank profits from card fees – and the harm they do to consumers -- are still the hard objects beneath the policy mattress.

P.S. Credit Cards: a Two-headed Hydra?[21]

A final note on a second way that credit cards hurt consumers: high interest rates. Unlike debit cards, credit cards give consumers a revolving loan that provides consumers with the convenience of getting goods before payment, but also the possibility of late fees and exorbitant interest rates. Credit card interest rates range from about 14 to 20 percent initially but can approach the limit of 29.99% once penalty interest rates kick in.[22]

As of July 2019, about 42 percent of American households held some type of credit card debt.[23] The average for balance-carrying households was $9,333. Although lower-income people are less likely to use credit cards, those that do can easily fall into a financial trap. Households with the lowest net worth (zero or negative) hold an average of $10,308 in credit card debt.

Figure 3



Some in Congress are pushing to cap credit card interest rates,[24] but current proposals would leave them relatively high. Moreover, the banking lobbies can provide powerful resistance to any change.

There's an argument that people on tight budgets should be disciplined enough to avoid using credit cards altogether, especially since credit cards tend to entice consumers to spend more than they would using cash.[25] Along comes Amazon's new credit card targeted to lower-income people and those who want to rebuild bad credit scores.[26] The new card is designed with some incentives to pay on time and offers modest rewards, but also hits consumers who pay late with very high interest rates. Rather than reducing costs by largely bypassing bank interchange fees as Alibaba did with Alipay in China, its American cousin appears more interested in expanding credit card sales in ways that might further exploit low-income consumers. Offering a credit card to a shopper who can't afford 28% in penalty interest could be likened to offering a recovering alcoholic help in staying on the wagon by making it easier to buy liquor, thereby proving to his therapist that he can resist temptation, resulting in yet easier access to liquor.

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