The push to regulate the payment card industry threatens consumers.

The War on Plastic

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The vast expansion in the use of payment cards of all sorts counts as one of the unnoticed marvels of the modern age. Think back 35 years, and no one left home without a wad of cash and American Express Travelers checks. Foreign travelers would sometimes even carry a letter of credit to cover the expenses of a European jaunt. All that apparatus is now replaced by a magnetic strip on a piece of plastic.

Individuals today can turn routinely to a few thousand banks and credit unions to obtain one of many ubiquitous credit or debit cards. The payment industry contains a number of networks that actively compete to recruit both the merchants and cardholders on opposite sides of the same market. Rates of expansion in payment card use continue to be high in the United States and Europe, while the use of cards in developing nations (e.g., India and China) moves forward by leaps and bounds.

The advantages of electronic transactions — swift, reliable, and silent — over clunky checks and bulky cash are apparent to consumers. To be sure, payment cards will not fully displace cash or checks anymore than sale has displaced barter or e-mail has eliminated snail mail. But the trend seems both inexorable and unmistakable. To the unpracticed eye, this industry deserves plaudits, not condemnation. What's not to like?

Apparently plenty, because a second side to this story becomes painfully apparent as soon as one signs on to work for one of the major card networks — a role that we have both played in working for Visa. Like the Holy Roman Empire, the payment industry has been embroiled in its own 30 Years War, as it has been bombarded by a continuous procession of antitrust lawsuits in the United States. These suits allege that the industry has committed the two cardinal sins of collusion under Section 1 of the Sherman Act, and monopolization under Section 2.

The damages demanded in the latest round of suits against Visa and MasterCard, now consolidated in federal court in Brooklyn, could by the time of trial approach a cool $1 trillion. That figure exceeds by several orders of magnitude the total value of the firms that run the payment card networks. It also approaches the combined value of the financial stalwarts that have historically owned the credit networks, such as J.P. Morgan Chase, Bank of America, and Capital One.

If these antitrust claims were well-conceived then, like Rick in *Casablanca*, consumers have all been sadly misinformed. The entire foray into payment cards would stand judicially condemned as a social mistake because, really, we would all be better off if we were to keep a stiff upper lip and make do with the payment choices of the 1950s.

The assault on the payment industry is not just domestic. It is also in high gear overseas. There, the attacks on the industry come not from civil antitrust litigation, but in the form of administrative proceedings that share a common objective with the new wave of American litigation. Regulators, and the merchants prodding them to action, want to limit what (some) card companies charge their merchant customers.

Civil antitrust litigation is undoubtedly more pernicious than mere administrative action because it carries mandatory treble damages. However sensible treble damages may be for secret cartels, they are a clear anachronism for interchange rates, this most public of offenses. But, as is so often true with thorny cases, we have yet another faux crisis for which no regulation seems the preferred solution. Let us explain why.

PLATFORMS IN TWO-SIDED INDUSTRIES

The payment card industry is defined by the problem of platform economics. On one side of the industry are cardholders who want access to their financial resources to make purchases anywhere in the world at any time. On the other side are merchants who want to supply those cardholders. In a

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world of zero transaction costs and perfect information, any form of payment is as good as any other because, by definition, there are no time delays or fraudulent transactions. People, both at home and abroad, could acquire exactly what they want when they want it. The differences between cash, checks, and credit cards would be inconsequential. Geographical distances and national boundaries would disappear into insignificance. Every person could become producer, consumer, and middleman at no cost.

But as Ronald Coase has repeatedly reminded us, the real world is defined by positive transaction costs and imperfect information. The way of doing business really matters, especially in network industries serving huge customer bases. Payment card systems enable merchants and consumers to let any given consumer purchase from any given merchant at significantly reduced cost. The efficiency gains in such transactions are as large as routing phone calls through an exchange instead of laying down separate wires linking every pair of individuals who might want to phone each other.

Payment card systems also enable merchants and con-

sumers to shift payment risk to firms that specialize in analyzing—and minimizing—the odds that the transaction will crater. By signing on to a system like Visa, MasterCard, or American Express, a merchant can shift — effortlessly, and thousands, if not millions, of times per day — the risk that a given consumer will not have sufficient funds available to cover a purchase to a financial institution that can far better judge the cardholder's creditworthiness.

ENTICING PARTICIPANTS Bringing both sides on board a single platform, however, is no mean feat. A payment card system could try to solve this problem by figuring out the costs on each side and charge merchants and cardholders only their respective costs. Even assuming, however, that these costs could be disentangled, this "solution" might not actually solve the problem because it ignores the profound interactions between the two sides of this two-sided market. Either merchants or cardholders might have relatively more attractive substitutes for the service offered by the payment network, so one or the other might balk at paying its share of the costs.

Think here of the situation of a bar-owner who has found that he makes more money by attracting men and women in equal proportions. The bar faces the same cost for providing a drink to a woman as it does to a man. But it finds that charging the same price to men and women attracts a disproportionately high share of men. Women, it turns out, are the scarce commodity, and they can be induced to come into the bar only when, as a class, they receive a subsidy from the men. Deny the subsidy and the women will not come—and soon the men will not come either. In overcoming this problem, the transaction costs really matter. There is no easy or elegant way to have every man pay a tiny direct subsidy to each woman at the door. But it is relatively trivial for bars to step into that role by charging men higher prices for drinks than women, which they often do.

This same logic carries over to competition among payment systems. With most payment systems, cardholders are relatively scarcer than merchants. They typically decide how to consummate a particular transaction among the several forms of payment that they carry and that merchants choose to accept.

Credit cards face competition from two historically dominant forms of payment: cash and check. Whereas private payment systems are relatively self-sufficient, both checks and cash receive large implicit subsidies. Checks are cleared at par, which means that neither the person who writes the check nor the merchant who receives it has to pay any fee to run the check through the banking system. The Federal Reserve remains the primary clearinghouse for checks, with the costs of the vast operation necessary to process the 18 billion or so checks that Americans write every year buried in its budget. Cash is printed by the United States, which goes to great expense to block counterfeit bills while making sure a sufficient supply of legal tender is otherwise available. It faces similar issues with minting coins.

With both cash and checks, all the transaction costs are covered through taxes. The user of either cash or checks faces no costs at the margin when using these payment systems in particular transactions. Two consequences typically follow: First, the subsidy leads to a general overuse of both these forms of payment. Second, payment cards have to structure their payments so as to compete with their zero marginal cost feature. The response seems clear: payment card systems tend to load up prices on merchants and use the revenue to track down and lure in potential cardholders.

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COOPERATIVES VS. INTEGRATED FIRMS

How this feat is accomplished depends on how different organizations run their respective businesses. Historically, American Express and Discover were fully integrated operations that coordinated the interdependent demand of cardholders and merchants by setting the price directly to both. They earned their keep by holding back from the merchant some of the purchase price paid by the cardholder. Their strategies differed, however, because Discover started with a strong base of customers and had to lure in the merchants by supporting that side of the market. American Express worked the opposite way, and thus had to court consumers.

Yet for both Discover and American Express, their exact fees typically vary with the retail environment. Big box stores such as Home Deport, Wal-Mart, and Costco may pay as little as 1 percent of the transaction amount in merchant discount. Smaller merchants pay significantly higher fees that often exceed 4 percent.

For Visa and MasterCard, the task of getting both sides on board is somewhat more complicated. Visa and MasterCard have historically been organized as cooperatives that do not contract directly with cardholders or merchants. The cardholder does business with a card "issuing" bank while the merchant does business with a merchant "acquiring" bank. Visa and MasterCard indirectly influence prices for cardholders and merchants by setting the rate of exchange between issuers and

acquirers, known as the interchange fee. When a cardholder of a particular bank uses his or her card with a merchant signed by another bank, the funds flow from issuer to acquirer to merchant, with issuers paying acquirers the total less the centrally set fee. Acquirers then take an additional cut before passing the remaining funds on to the merchant. Although two fees are more than one, the sum of the two fees together is generally a bit less than the single fee charged by American Express.

OUTMODED ANTITRUST The difference in industry structure creates real points of friction when coupled with the vague generalizations of the antitrust laws, which frequently lead to bizarre and abusive applications. We make this observation from the perspective of the small government libertarian, or classical liberal, who thinks that the major function of the state is to limit force and fraud, neither of which is at issue in this situation. Once force and fraud are controlled, it becomes an uphill battle to find settings where additional use of government power will yield social benefits in excess of the costs of their implementation. Those costs include at a minimum the direct costs of battling over the nature and form of the regulation, the administrative costs of setting up and operating the program, and the error costs that flow from all these operations.

We start from the simple point that all sorts of business arrangements have multiple consequences, some good and some bad. Both antitrust law and direct rate regulation presuppose that government officials have a real competence to sort out the wheat from the chaff, so that they prohibit only inefficient business practices. But in dealing with the antitrust laws, recall a second Coasean maxim: Virtually anything you do gets you into trouble. Raise prices and you are part of a cartel. Lower prices and you are guilty of predation. Keep them constant and you are engaging in monopoly maintenance. The simple truth here is that all practices that are socially successful produce economic losers as well as winners. The great risk is that too many market losers become big-time winners through the misguided intervention of antitrust law. Regulation has the same set of vices.

This gloomy assessment is not just a matter of theory. It is confirmed by experience. The Reserve Bank of Australia under the leadership of Ian MacFarlane gave all sorts of reasons, wrong in our view, to accept the notion that credit card transactions "coerce" merchants (by expanding options, of course). MacFarlane's stunning conclusion was that society as a whole would be better off if consumers were to revert to the payment Stone Age of cash and checks. In its effort to constrict the use of credit cards, the Reserve Bank clamped down on interchange fees on four-party systems, cutting them by 43 percent, from 0.95 percent to 0.55 percent, by no known methodology. Yet the bank did not regulate the price that American Express charges merchants or meddle with the internal transfer that American Express makes from its acquiring side to its issuing side (i.e., the American Express "interchange" fee). Nor did it benchmark the total price that merchants should pay to accept four-party payment systems to what American Express charges its merchants. Two different organizational structures with identical functions got different treatments.

The Reserve Bank is not the only regulatory body to draw a distinction between integrated firms and cooperative arrangements. The European Commission has launched its own assault on the payment card industry. Like their counterparts in Australia, the commissioners have focused on the industry's pricing model. In her remarks announcing the European Commission's interim report on the industry, commissioner Neelie Kroes complained that banks have earned "absolutely abnormal profits" through payment cards and warned that they will face "consequences" unless they alter the business model for the industry. Like their colleagues in the Reserve Bank, however, the European Commission members have turned a blind eye to the three-party systems even though they use precisely the same pricing model.

Predictably, the added regulatory burden on four-party systems is moving the market. Issuers in Australia have increased fees and cut rewards programs on their Visa and MasterCard programs. They have also begun to issue so-called companion cards on three-party systems, instructing cardholders to use them wherever possible to get their customary rewards benefits. As a consequence, three-party systems such as American Express and Diner's Club have increased their collective share by roughly a quarter, from 14 percent to 17 percent, since the Reserve Bank of Australia intervened.

Closer to home, the overhang of potential antitrust liability has pushed MasterCard to abandon the cooperative business model on the theory that what is good for the goose is every bit as good for the gander. Although MasterCard remains a four-party system, financial institutions no longer own a controlling stake in the company. Third-party investors are now empowered to set the rules and interchange rates that have been constantly challenged as the outgrowth of an illegal conspiracy.

ENTRY FIRST

Yet, as is so often the case, the regulation trails the market. Online payment systems do not fall under the traditional categories of cash, check, or credit. New entrants to the payment systems market, such as PayPal, DebitMan, and Pay by Touch, have undercut any claim that the payment industry is a cloistered monopoly. The principal innovation of these firms is that they use new devices to initiate transactions (such as cell phones and fingerprints) and, like American Express, Discover, and (going forward) MasterCard, these firms avoid having financial institutions collectively determine rules and rates. Thus, they do not face the regulatory and antitrust risks of traditional payment card companies.

In addition, further competition can come from traditional retail firms that are among the largest users of credit cards. Wal-Mart (which has sued the credit card companies for antitrust violations) wants to open up a bank, even one that cannot take deposits, to reduce its cost of processing electronic payments.

These developments hammer home an old truth: Open entry on a level playing field does more to open markets than antitrust litigation or administrative fiat. Recall in this context

the regulation of cable television rates about 14 years ago, which was intended to shut down some hidden well of excessive profits. The predictable upshot: reduced expenditures on programming and an increase in shopping channels. The simple point to note here is that as long as there are MasterCard, Visa, Discover, and American Express (not to mention the federal government), the market is not run by a single firm. And do not dismiss the possibility that some of the newly emerging competitors will become big market players.

Always remember, markets impose their own remorseless form of rate regulation, and we are extremely doubtful that, given this reality, any system of government rate regulation could ever achieve its stated objective of improving competitive balance. All that can be said for regulation is that it is much less corrosive than civil litigation. Civil litigation carries the aforementioned mandatory treble damages and, thus, the unsettling possibility that Visa and MasterCard, having adopted different ownership structures, will resolve the litigation on different terms. This legally created form of imbalance is just asking for trouble.

There is, in closing, something more at stake here. Antitrust law works best when it concentrates on horizontal agreements like bid rigging and price fixing that lead to predictable deviations from market outcomes. Unfortunately, in this post-Chicago age, it is no longer fashionable to concentrate on cases where a clear theory shows the way. Instead, we use government and private suits to attack business arrangements that make platform industries work, without realizing the dangers of criticizing second-best solutions when we have no clue what the first-best solution might be.

Compounding the problem, we expand the cases that attack unilateral acts of supposedly dominant firms so that one kind of contractual provision after another — exclusives, tie-ins, bundling, loyalty discounts — is always under the gun. Yet once again, all we know for sure is that each of these practices is commonplace among firms that lack any dominant position, which means that all of them have to have some efficiency advantage. It is, therefore, risky to start off with a presumption that these practices are abusive when implemented by firms with a significant market presence.

This constant antitrust and regulatory struggle has real social costs. It forces firms to devote substantial time and energy to defending lawsuit when they could be improving operations, expanding product lines, overhauling marketing strategies, or preserving security and privacy interests. These costs are indirect and hidden. They are also hard to measure. Although they are easily scoffed at or ignored, they are all too real.

The great danger of antitrust law today is that it will stifle the competition that it is intended to foster. It threatens to render illegal a wide range of practices, as yet imperfectly understood, on the ground that, because of their market successes, innovative businesses should be presumed guilty in the eyes of antitrust lawyers and government enforcers. R

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