Retail payment systems in New Zealand

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Introduction

1.1 Thank you for this opportunity to provide feedback on MBIE's Issues Paper, "Retail payment systems in New Zealand."

1.2 I am Head of Research with The New Zealand Initiative, a Wellington-based think-tank supported by New Zealand's leading businesses. The Initiative engages in public policy research for a free and prosperous New Zealand. Previously I served as Senior Lecturer in Economics at the University of Canterbury; I am currently Adjunct Senior Fellow with the Department. I can be reached at 04 499 0790 and at eric.crampton@nzinitiative.org.nz

1.3 I have reasonable background in cost-benefit assessment and market failure theory. At the University of Canterbury, I taught on the principles of cost-benefit analysis. I also occasionally taught the Department's intermediate microeconomics course, which provided a strong focus on defining market failure. I now teach Introduction to Public Finance at Victoria University's School of Government, which also covers cost-benefit assessment. With Tyler Cowen, I edited Market Failure or Success: The New Debate (Edward Elgar, 2002); I also wrote the entry on market failure for the Encyclopedia of Law & Society (Sage, 2007). I am not, however, expert in the economics of credit card interchange fees.

Market Failure and Problem Definition

2.1 "Retail payment systems in New Zealand" suggests broad inefficiency in New Zealand's payment regime.

2.2 The paper argues that customers have incentive to shift to cards providing larger rewards, and with higher associated merchant fees, and to shift from EFTPOS to reward-bearing cards.

2.3 The paper argues that the real resource costs associated with credit card use over EFTPOS are of the order of $137 million per year. The paper notes that consumers receive benefits from credit cards over EFTPOS and that these benefits would need to be counted against the real resource costs of credit card use.

2.4 However, the paper also argues that where credit card users pay off their cards in full each month, those users have no need for the card's credit facility as they could have used EFTPOS (paragraph 193). These users are deemed by the authors to receive no benefit from using credit over EFTPOS other than rewards through card loyalty schemes. The authors view reward schemes as constituting a transfer (from merchants, from users of lower fee cards, and from non-card users) rather than a net benefit.

2.5 The paper then argues that card loyalty schemes increase the cost of payment processing by some $45 million per year: the value of the extra real resources used to process credit transactions among those deemed to receive no benefit from the credit transaction other than card loyalty rewards. The authors go on to conclude this constitutes a market failure.

2.6 This key finding is fundamentally erroneous in two key respects. First, the conclusion itself is dependent on an *assumption* that that users of credit cards derive no benefit, when this is both

unproven and unlikely. Secondly, simply deciding that some class of transaction has no benefit to the people involved does not constitute a market failure.

2.6.1 A market failure obtains where one of the conditions underlying the First Welfare Theorem fails. Externalities are a very common form of market failure – for example, dumping effluent in a river to the detriment of downstream users. In that case, the marginal cost facing the decision maker diverges from the marginal social cost and too much dumping is expected relative to an optimum. But the market failure case advanced in this paper is tenuous at best. Normally, parties linked by a contractual nexus are not seen as imposing externalities on one another. To take a classic example, a baby crying on an airplane *inconveniences* other passengers and imposes cost on them, but does not impose any kind of policy-relevant externality. If consumer willingness to pay for baby-free flights were high enough, airlines would provide them. The baby, and other passengers, are linked through a contractual nexus via the airplane ticket which does not guarantee a baby-free experience.

2.6.2 In this case, users of credit cards, merchants, and EFTPOS users are similarly linked through contractual nexus. Card users decide whether or not to subscribe to different types of cards with different fees; merchants decide whether to accept credit cards and whether to apply a surcharge if they do; and, shoppers decide whether to shop at establishments accepting cards.

2.6.3 Consider again an airline analogy. The MBIE paper asserts that credit card users impose costs on non-users and, because those users do not consider the costs of their decision on others, an externality obtains. When you fly internationally, the airline typically provides free alcohol. Do passengers who partake in free drinks impose an externality on tea-totalling passengers by slightly increasing the average cost of tickets? Hardly. Airlines decide what is included in an airfare, and customers choose across airlines and ticket classes. They are linked through that contractual nexus, and competitive pressures across airlines for passengers provides far stronger incentive to get the right mix than would any MBIE-led regulatory intervention.

2.6.4 MBIE's position here on the irrelevance of contracts in determining whether an externality obtains is worrying.

2.6.5 Finally, simply proving the existence of a market failure, which MBIE has failed to do, would be insufficient basis for intervention. Intervention to address market failure is only warranted where that intervention is supported by cost-benefit assessment. Harold Demsetz's 1969 classic "Information and Efficiency" explains that we need comparative institutional analysis: markets fail, but government intervention does not automatically bring about Nirvana. Interventions consequently need to be backed up by a case demonstrating that outcomes under real-world interventions, taking account of implementation costs and unintended consequences, improve welfare as compared to real-world market outcomes. Cost-benefit assessment is needed.

Benefits of credit card use for those who pay off balances in full

3.1 It is highly likely that consumers using credit cards who pay their cards off in full each month receive valuable benefits from card use, over EFTPOS, other than simply reward schemes.

3.2 Credit cards are considerably simpler in use in online transactions than EFTPOS.

3.3 Credit cards come with dispute resolution facilities in case of disputed transactions. Similarly, credit cards can provide extended warrantees, fraud protection, and simplicity in transactions when travelling abroad.

3.4 Credit card users enjoy an interest-free period on all purchases equal to the distance between the purchase and the next credit card payment due date, multiplied by the customer's relevant interest rate. For those consumers on a line-of-credit mortgage that acts as their transaction account for EFTPOS purchases, EFTPOS purchases immediately draw interest at the consumer's home mortgage rate. Credit card purchases allow a deferring of that interest. This is a transfer rather than a net benefit (from the bank to the card user via forgone interest), but is a plausible reason for using a card while paying it in full each month.

3.4.1 Question 3 of the Report asks why the revolve fee has declined. The mechanism above may prove part of the answer. Customers with the type of mortgage described above will have reasonable incentive to use credit cards, and to shift their balances in full each month to their lower interest mortgage. The authors of the study should at the very least investigate the uptake of this type of mortgage.

3.5 Where consumers do draw benefits like those described in 3.1 and 3.2, those have to be set against the real resource costs of credit card use over EFTPOS. Failing to do so is inconsistent with sound cost-benefit assessment. I consequently disagree materially with the logic underpinning the assessment of inefficiency in the credit card market.

3.6 Even if it were the case that these benefits were inframarginal to any customer's decision, and even if it were the case that many of these customers decided to use credit over EFTPOS because of the rewards schemes, sound cost-benefit assessment would *still* require the tallying of the benefits listed above. Those benefits would be forgone in any counterfactual shift to EFTPOS, and their value would need to be assessed.

3.7 I also have some reservations about the analysis undertaken by Treasury in its feedback to MBIE on this paper.

3.7.1 I have been provided Treasury's advice to MBIE on this paper under the Official Information Act in the form of an earlier draft of the paper where Treasury's comments were included. Treasury's analysis did not question the $44 million then-listed as additional cost but rather only requested that the introduction outline how this was calculated. If sufficient detail were provided in the earlier draft to make clear that the $44 million rested on an assumption that consumers paying their balance in full received zero benefit from use of credit card (as compared to EFTPOS) other than scheme rewards, Treasury should have advised MBIE of the error in its cost-benefit assessment. Those sections of the report provided to me were redacted, so I cannot tell whether Treasury's comments caused MBIE to demonstrate their workings, which showed that they simply rely on an assumption that credit card users receive no benefit from that use if they pay off their balance in full, or whether those workings were provided and Treasury failed to point out the inadequacy of that analysis.

3.7.2 At draft paragraph 236 (draft Chapter 5, first section), where MBIE then noted that government intervention was likely to be necessary, Treasury's advice was "Would be good to go further here and link to the cost-benefit case for acting. MoF's office have been vocal that market failure alone does not justify intervention, there has to be the case that regulation will increase the net social benefit too. Some level of government intervention would decrease the inefficiencies and save consumers money? Or similar…". A second Treasury commenter noted that MBIE's wording that "some level of government

intervention is required" was too strong, as the risks of intervening needed to be weighed against any identified inefficiencies of existing arrangements. Both point to the need for cost-benefit assessment to underpin any intervention, but the draft version of the issues paper suggests that MBIE has already decided that some level of intervention is required. Treasury was correct in its advice in this section. The final draft incorporates too little of this advice, and does disservice to the cost-benefit assessment framework by assuming that a class of transactions is of no benefit to the consumer.

3.8 The mechanism described in 3.3 is a transfer rather than a net gain, but muddies some of the welfare analysis. Simultaneous to any transfer that might obtain from one customer to another – which again is not necessarily any kind of market failure given the existence of a contractual nexus among parties – is a transfer from banks to those customers with mortgages able to reduce their interest charges in this way.

3.9 Even leaving aside the substantial error inherent in assuming zero benefit to those consumers who pay off their balances in full each month, there are other problems.

Credit card fees, retailer choice, and surcharges

4.1 There is a neutrality theorem that applies where merchants impose fees for use of credit cards (Gans and King, 2003). In that case, credit card fees simply do not matter.

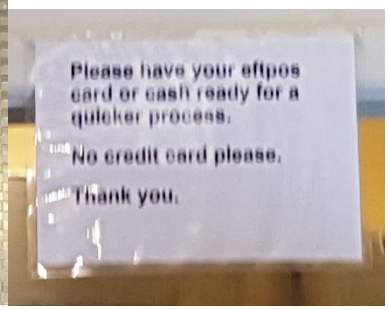
4.2 "Retail payment systems in New Zealand" notes high penetration rates of credit cards (para 161) and the relative infrequency of surcharging (cited as less than 10% of transactions weighted by turnover at paragraph 158). Both of these are presented as suggestion that merchant uptake of credit cards is less than voluntary, and that merchants are constrained against using surcharges because of consumer objections.

4.2.1 Walking around Wellington, it is *easy* to find retailers who either do not accept credit, or who only accept it with a surcharge.

4.2.1.1 Moore Wilson targets high end shoppers – the kind MBIE would expect only care about reward scheme points and who MBIE would expect would pressure retailers to accept credit. Until recently, Moore Wilson did not accept credit at all. Now it accepts credit with a surcharge.

4.2.1.2 Little pieces of black electrical tape over the credit card button on the EFTPOS machine are very common. Just walk around town, pop into cafés, small restaurants, and dairies, and look!

4.2.1.3 My unscientific survey of 18 January 2017 encompassed all cafés and restaurants I visited that day. N is equal to 2 for that day. I have attached below pictures from both venues. The first reads "2% surcharge on Paywave & Credit Card transactions". The second reads "Please have your eftpos card or cash ready for a quicker process. No credit card please. Thank you."



4.2.1.4 The picture on the left comes from a small coffee shop tucked into a little nook at the corner of Featherston and Brandon Street, my local. A debit scheme card using Paywave that carries higher fees to merchants than standard EFTPOS there would come under the same surcharge as applies to credit card users. The picture on the right is from Chef's Palette on Woodward Street. This kind of thing really is not uncommon – though the café's surcharge for Paywave is the first I have seen.

4.2.2 MBIE's contention of market power, or consumer backlash, preventing retailers from using the little black piece of electrical tape or a surcharge simply does not reflect reality. It does not survive a casual stroll through Wellington retail shops, cafés and restaurants.

4.2.2.1 While MBIE cites relatively large numbers of retailers that accept credit, weighted on a transactions volume basis, as evidence of some kind of market power forcing people to accept credit cards, isn't the simpler explanation that a lot of retailers and customers find it beneficial to run transactions via credit, and that other retailers and their customers do not find it worth the higher cost? Advancing a "they're forced to accept it" argument surely would require some more systematic analysis of the types of retailers that accept credit with no surcharge, those who accept only with a surcharge, and those who accept with no surcharge, and seeing whether there really is some power argument that applies to one class of retailers but not the others.

4.3 If we go back to first principles, and accept for the moment MBIE's contention that many customers select high-fee high-end cards solely for the rewards schemes, we should expect that retail markets will segment. Some outlets will provide lower prices and refuse credit cards entirely, or accept them only with a surcharge – they will focus on more value-conscious customers. Other outlets will focus on higher end customers. The greatest potential for transfers, either from consumers using EFTPOS to those using credit, or from those using lower fee cards to those on reward schemes, will be in places where lower and higher end consumers do not segment but rather pool.

4.3.1 The greatest potential for such a pooling equilibrium is in grocery outlets serving diverse communities. Groceries will be a fairly large fraction of families' regular expenditures. But, the MBIE paper also complains that large grocers have been able to negotiate very low transaction fees relative to other retailers. The place where there is greatest potential for transfers from poorer to richer customers via credit card fees is also the place where MBIE

tells us that it isn't happening, because the fees have been negotiated down to levels where it wouldn't be happening. It is odd that the MBIE paper does not recognise the tension between its argument of widespread transfers and its complaint that large grocery chains have negotiated lower fees. The latter would mitigate the former.

4.4 If MBIE wanted to make a case for inefficiency despite many retailers choosing either not to accept credit, or to accept it only with a surcharge, it could point to that the neutrality theorem found by Gans and King applies where *all* retailers use surcharges. When only some retailers use surcharges, welfare implications are more ambiguous. But one does begin to get the feeling that MBIE is searching for reasons to deem credit card markets inefficient in order to justify promulgating new regulations.

Alternative payment systems

5.1 MBIE asks if there are any emerging payment methods the paper has missed. Snapper is reasonably important in the Wellington market and shows growth potential. Starting as the payment scheme for busses, it can also be used for parking meters, the cable car, and taxis.

Summary and conclusion

6.1 There is little basis for the paper's finding of widespread inefficiency. The paper provides no substantial evidence of market failure. And the critical finding of $45 million in efficiency losses rests on an unwarranted and unsupportable assumption that users paying off their balances in full each month derive no benefit from using credit over EFTPOS.

6.2 The paper's suggestion of large transfers to users of high end credit cards requires greater support than is provided in the paper. In particular, it needs to wrestle with market segmentation, where outlets catering to customers unlikely to use rewards-laden cards may be less likely to accept credit without a surcharge. It needs also to think harder about implications where the grocery market, where the greatest pooling potential seems to exist, is also the one where retailers have negotiated relatively low credit card fees.