

TESTIMONY

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Committee on Financial Services
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Hearing on
Credit Card Interchange Fees Act of 2009
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I would like to thank Chairman Frank and Ranking Member Bachus for inviting me to testify. Members of the Committee: My name is David S. Evans. I teach at the University of Chicago Law School where I am a Lecturer and at the University College London where I am Executive Director of the Jevons Institute for Competition Law and Economics and Visiting Professor. Despite the law school affiliations I am an economist. I've written widely on the payments card industry from both a business and policy perspective. I'm the co-author of *Paying with Plastic: The Digital Revolution in Buying and Borrowing* which has become the standard reference work on the industry.

I represent solely myself at this hearing. In the interest of transparency, Visa funded my research on the payments card industry for many years. In recent times I have been a business advisor to many of the innovative entrants into the payments industry, including several companies that compete with the incumbent networks and issuers and which offer merchants payment services at much lower fees than do the incumbents.

Economists have been studying the subject of interchange fees and related practices since the early 1980s. There has been a flurry of research in the last decade. Much of the research is based on a new field of economics known as two-sided markets. This field studies businesses that create value by bringing different kinds of customers together. A stock exchange, for example, brings liquidity providers and liquidity takers together while a matchmaking service brings men and women together.

Payment cards help merchants and individuals to transact with each other. This research provides several insights. I have appended to this statement an article that I co-authored with Professor Richard Schmalensee, “The Economics of Interchange Fees and Their Regulation” which was published by the Kansas City Federal Reserve Bank and provides many of the key references.

First, it turns out that it is very difficult to say in practice that the interchange fee charged by a payment network is too high, too low, or just right from the standpoint of public welfare and even more difficult for a regulator to have any confidence that it could establish a better interchange fee. This argues for caution in price regulation of interchange fees. Government regulation is appropriate when it is possible to both identify a market failure and fix that failure without creating unintended consequences. That is not possible with the current economic state of knowledge on interchange fees. HR 2382 wisely stays away from specific price regulation in my view.

Second, any change that is made to the pricing for one side of a two-sided business will tend to have an opposite effect on the other side. Two-sided businesses recover their costs and earn profits from both sides. So if a two-sided business earns less on one side it usually has to earn more on the other side. Many daily newspapers are charging people more because they are making less from advertisers. In evaluating HR 2382 it would be prudent to anticipate how the changes to merchant pricing will ultimately affect cardholders. There probably isn’t a free lunch here.

Third, the customers of two-sided businesses interact a lot. The platform makes money by promoting valuable interactions. But the platform has an interest in policing bad behavior. eBay is a two-sided business for example. It tries to get buyers and sellers to swap a lot of stuff. But it also has rules that buyers and sellers have to follow. eBay protects buyers by kicking sellers that repeatedly fail to meet their end of the bargain off of eBay. I mention this in the context of HR 2382 because many of the policies that the bill seeks to restrict at least arguably benefit one side of the market—individuals who carry cards and want to use them to pay. A card brand can provide benefits to individuals by assuring them that their card will be accepted everywhere and that these individuals won’t be

surcharged. One could also argue that the network policies that are the subject of HR 2382 are anticompetitive or are contrary to the public interest for some other reason. But I believe it would be prudent to consider the pro-competitive explanations as well as the anti-competitive ones. Most likely there's no free lunch here either. Prohibiting the networks from imposing various restrictions will likely impose some collateral cost on consumers.

There are many elements to this bill. I have not done a careful study of it. I would like to suggest however that payment cards is one of the most complex industries that economists study. There are many moving parts. There are also many interdependencies between the merchants, cardholders, processors, acquirers, networks, and other players. As a result there is a greater risk in this industry than in others for government interventions to have unintended consequences. Finally, I am not aware of any systematic evidence that would support the position that the payment card network practices targeted by HR 2382 cause overall public harm or that the types of restrictions on payment card networks suggested in the bill would inure to the public benefit.

Thank you again for the opportunity to appear before this Committee. I would be happy to respond to your questions.