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Discounts and Surcharges: Implications for Consumer Payment Choice

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For the past several decades, payment card networks in the United States have employed rules that prevented merchants from steering customers toward payment methods that are less expensive for merchants to accept than network-branded payment cards. The payment card networks argue that these "no-steering" and "no-surcharge" rules, coupled with interchange fees, are important to achieve the right balance between consumer usage and merchant acceptance of their cards. This strategy contributed to dramatic growth in card payments by consumers, and a corresponding increase in fees paid by merchants to accept card payments. To gain control of these expenses, merchants have sought the ability to steer customers toward lower-cost payment methods. They argue that consumers would benefit as merchants pass on their payments acceptance cost savings to customers in the form of lower prices for goods and services.

Recent legal and regulatory changes in the U.S. payment card industry have enhanced merchants' ability to offer their customers a discount from a regular price based on the payment instrument used. Most card networks still prohibit merchants from charging their customers a surcharge for paying with the network-branded cards, but certain types of merchants are allowed to charge a so-called "convenience fee." This *Briefing* reviews the current landscape for payment discounts and surcharges, considers whether they influence consumer payment choice, and offers several possible policy responses.

Offering Payment Method Discounts

Since 1981, merchants have been allowed by the Cash Discount Act to offer a discount to customers who pay with cash or check instead of credit cards. However, as debit cards became available in the mid-1980s, payment card networks, such as Visa, MasterCard, and American Express, did not allow merchants to offer a discount for paying with a debit card rather than a credit card.[1] The recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act changes that. The act requires the card networks to allow merchants to discount based on whether payment is by cash, check, debit card, or credit card. In addition, a federal judge approved an antitrust settlement between the Department of Justice (DOJ) and Visa and MasterCard, which requires the card networks to relax their rules constraining merchants from offering consumers discounts based on the payment method, brand, and product. Under the settlement, for example, merchants may offer a discount for using a PIN debit card instead of a signature debit card, a Visa credit card instead of a MasterCard credit card, or a Visa nonreward credit card instead of a Visa reward credit card.

The effectiveness of the DOJ settlement is limited, however, because American Express and Discover have more restrictive rules in place. American Express prohibits its merchants from offering different levels of discounts across card brands. Although Discover allows its merchants to surcharge paying with a card, they are prohibited from treating Discover cards differently from the other card brands. Thus, merchants who accept American Express or Discover cards in addition to other network-branded cards cannot take advantage of the DOJ settlement.

Even if merchants *could* offer a broader set of discounts, some economists are skeptical about the influence of such discounts on consumer payment choice.[2] They argue that discounts from a purchase price have a smaller impact on payment behavior than surcharges of the same value. To understand this, consider the following two scenarios: In the first, the merchant sets a regular price of $100 for credit card users and offers a $2 discount to debit card users. In the second scenario, the merchant sets a regular price of $98 for debit card users and imposes a $2 surcharge to credit card users. In both scenarios, debit card users pay $98 and credit card users pay $100. However, consumers may view a $2 discount for paying with a debit card as a gain and a $2 surcharge for paying with a credit card as a loss. Behavioral economics explains that consumers are more sensitive to a loss than to a gain.[3] In the context of consumer payment choice, this implies that consumers would react more strongly to surcharges than to discounts. In other words, more consumers would choose debit cards rather than credit cards in the case of surcharge (the second scenario) than in the case of discount (the first scenario).

There is little empirical evidence on whether consumers react differently to surcharges and discounts. Previous studies on consumer payment choice have found that consumers were sensitive to both positive fees, such as the fees assessed by banks to discourage the use of PIN debit rather than signature debit,[4] and negative fees, such as rewards offered by banks to encourage the use of credit and signature debit cards.[5] While these findings suggest that discounts would influence consumer payment choice, they do not establish whether the influence of discounts is as strong as that of surcharges.

Convenience Fees, a Special Surcharge

The major card networks, except for Discover, do not allow merchants to surcharge but allow a few merchant sectors, such as governments, colleges and universities, to charge convenience fees. Convenience fees were introduced in the mid-1990s, in response to complaints by state and local governments.[6] While other merchants could pass on the cost of accepting payment cards by raising the price of goods or services to all of their customers, governments could not do so because government fees and taxes were largely set by law.

Initially, convenience fees were charged to customers for the option to pay bills online or by telephone as a substitute for mailing a check or paying in person.[7] In the late 2000s, the networks relaxed their rules in two ways. One change was to allow merchants and governments to waive the convenience fee for customers who made online or telephone payments using an instrument other than a credit or debit card—specifically a direct ACH debit. The second change was to allow governments to charge a convenience fee for face-to-face transactions. These changes represented a departure from the rule that the same convenience fee had to be applied to all payment instruments used over a particular payment channel, such as through the Internet. In 2011, Visa and MasterCard again relaxed their rules slightly. Prior to 2011 Visa allowed third-party processors to charge a convenience fee only for tax payments; Visa now allows third-party processors who process non-tax payments for governments and higher-education entities to do so. MasterCard's change permits the convenience fee assessed for debit cards to be different from that assessed for credit cards.

Card network rules on convenience fees vary. Discover has the least restrictive rules, while Visa's are the most restrictive. As mentioned, Discover allows all merchants to surcharge, while the other major credit card networks allow only certain merchant sectors to assess convenience fees. The main differences between Visa and two other networks—American Express and MasterCard—are for non-tax payments. Under Visa's rules, the convenience fee for such payments (1) must be a fixed amount, regardless of the value of the payment; (2) is charged only for payments over payment channels other than face-to-face (e.g., over the Internet or telephone); and (3) has to be the same for all payment instruments used in the alternative payment channel.

The influence of the current convenience fees on consumer payment choice is likely to be limited. First, merchant sectors that can assess a convenience fee are generally limited to two sectors—governments and higher education entities. Second, due to the limitations imposed by card networks, merchants cannot assess convenience fees that reflect merchant costs of accepting various payment methods. Visa has the strictest limitation—merchants who accept Visa cards cannot assess higher convenience fees for a credit card versus an ACH debit, so the fee will not influence the choice of payment method. Some government and higher education entities do not accept Visa cards for this reason. Merchants who accept American Express cards are less restricted—they can assess different convenience fees on cards versus ACH but cannot assess different convenience fees on debit versus credit cards. Merchants who accept MasterCard and/or Discover cards only are the least restricted—they can assess different convenience fees for different payment methods.

The Freedom to Surcharge

While merchants have greater freedom to offer discounts or assess convenience fees than before, they may not be able to significantly influence consumer payment choice unless they are also given freedom to impose surcharges.[8] Many economists agree that merchant ability to impose surcharges (or offer discounts) based on the payment instrument is generally beneficial in the countries where the payment card industry is mature.[9] Merchant surcharging enhances efficiency in the retail payments system by improving price signals consumers face when making payments. However, economists warn that imposing surcharges that exceed merchant's actual costs of accepting given payment instruments may make the retail payments system less efficient and harm consumers. When merchants impose excessive surcharges on a particular payment method, consumers would reduce the use of the payment method accordingly. This would result in a less efficient payment mix—the payment method that attracts excessive surcharges would be underused and some alternative payment methods would be overused compared with efficient levels of utilization. Consumers' welfare would also be lowered if alternative payment methods provided consumers lower transactional benefits than the payment method that attracts excessive surcharges, or if consumers paid higher surcharges.

Experiences in the other countries provide some insights into this. Merchants in a number of countries outside the United States are free to impose surcharges. While merchants in some of these countries rarely apply surcharges, merchants in Australia, the Netherlands, and the U.K. do so more commonly. In 2006, about one in five Dutch retailers applied a fixed amount debit card surcharge for purchases below a certain threshold value, which they set on average €10.[10] In Australia, almost 30 percent of merchants applied an ad-valorem surcharge ranging between 1.8 percent to 4 percent of the purchase price on at least one of the credit cards they accepted in December 2010.[11] In 2007, 19 percent of U.K. merchants that accepted card payments surcharged at least one card type. While ad-valorem surcharges ranging from less than 1 percent to 3 percent are relatively more commonly used by U.K. merchants for credit cards, flat surcharges ranging between 10 pence and £1.30 are more commonly used for debit cards.[12]

Consumers have responded to the surcharges in these countries. A study found that in the Netherlands debit card surcharges drove some consumers to use cash rather than a debit card and decreased debit card payments as a share of total payments by 8 percent.[13] A consumer survey in Australia found that around half of consumers who have a credit card would seek to avoid paying a surcharge by either using a different payment method that does not attract a surcharge (e.g., cash and debit cards) or going to another store.[14]

In Australia and the U.K., some merchants are now imposing surcharges that exceed their acceptance costs or are imposing surcharges in nontransparent ways. Such merchants tend to be concentrated in certain industries or payment channels, such as online transactions in Australia and the travel sector in the U.K.[15] Public concerns about excessive surcharges have led to regulatory interventions in both countries. In December 2011, the Reserve Bank of Australia published a consultation paper proposing to allow card networks to limit surcharge levels. The card network rules may limit surcharges to a reasonable cost of acceptance, but must not prevent merchants from fully recovering their costs.[16] In the same month, the U.K. government announced that it will ban excessive surcharges on all forms of payment across most retail sectors before the end of 2012.[17]

Encouraging competition in merchant sectors is perhaps the most favorable way to prevent excessive surcharges imposed by merchants. However, competition may not be sufficient to prevent excessive surcharges in certain merchant sectors. If that is the case, some type of regulatory intervention may be warranted. Simply monitoring merchant surcharges might work in some countries.[18] However, in other countries, more heavy-handed interventions such as capping surcharges may be needed to avoid negative consequences resulting from merchant surcharges.

Conclusion

Although U.S. merchants now have greater freedom to offer discounts on payment methods than before, this may have little impact on consumer payment choice. Some merchant sectors are allowed to charge convenience fees, but limited use of such fees prevents them from significantly influencing consumer payment choice. Granting merchants greater freedom to impose surcharges is likely to make merchants more influential in steering customers toward a payment method that reduces merchants' payment acceptance costs. However, giving merchants unlimited freedom to surcharge may make the retail payments system less efficient if merchants impose excessive surcharges. A regulatory authority may need to monitor or set limits on merchant surcharges in less competitive merchant sectors, as has been proposed in Australia and the U.K.

Endnotes

[1]Visa allowed merchants to offer discounts to PIN debit card users but not signature debit card users.

[2]Schuh, Scott, Oz Shy, Joanna Stavins, and Robert Triest. 2012. "An Economic Analysis of the 2010 Proposed Settlement between the Department of Justice and Credit Card Networks," *Journal of Competition Law & Economics*, 8(1): 107-144.

[3]A seminal paper was written by Karneman and Tversky. Kahneman, Daniel, and Amos Tversky. 1979. "Prospect Theory: An Analysis of Decision under Risk," *Econometrica*, 47:263-291.

[4]Borzekowski, Ron, Elizabeth Kiser, and Shaista Ahmed. 2008. "Consumers' Use of Debit Cards: Patterns, Preferences, and Price Responses," *Journal of Money, Credit and Banking*, 40: 149-172.

[5]Ching, Andrew, and Fumiko Hayashi. 2010. "Payment Card Rewards Programs and Consumer Payment Choice," *Journal of Banking and Finance*, 34: 1773-1787.

[6] Plunkett, Jim. 2008. "Credit Card Companies Change Rules on Convenience Fees," *Treasury Management Newsletter*.

[7]For more detailed history of convenience fees, see North Carolina Office of the State Controller. 2011. "Credit Card Convenience Fee and Surcharge Rules," May 23.

[8]In addition to the three major card networks, 10 states prohibit merchants from imposing surcharges to their card customers: California, Colorado, Connecticut, Florida, Kansas, Maine, Massachusetts, New York, Oklahoma, and Texas.

[9]See, for example, Economides, Nicholas, and David Henriques. 2011. "To Surcharge or Not To Surcharge? A Two-Sided Market Perspective on the No-Surcharge Rule," NET Institute Working Paper: No. 11-03.

[10]Bolt, Wilko, Nicole Jonker, and Corry van Renselaar. 2010. "Incentives at the Counter: An Empirical Analysis of Surcharging Card Payments and Payment Behaviour in the Netherlands," *Journal of Banking and Finance*, 34: 1738-1744.

[11]Reserve Bank of Australia. 2011. "Review of Card Surcharging: A Consultation Document," June.

[12]Office of Fair Trading. 2011. "Payment Surcharges: Response to the Which? Super-Complaint," June.

[13]See endnote 10.

[14]See endnote 11.

[15]See endnotes 11 and 12.

[16]Reserve Bank of Australia. 2011. "A Variation to the Surcharging Standards: A Consultation Document," December.

[17] *http://www.hm-treasury.gov.uk/press_148_11.htm*

[18]For example, the Commerce Commission in New Zealand is monitoring merchant surcharges. See *http://www.comcom.govt.nz/media-releases/detail/2010/commerce-commission-watching-retailers-credit-card-surcharges*

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