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Distributional Effects of Payment Card Pricing and Merchant Cost Pass-Through in Canada and the U.S.

Economics of Payments X, Suomen Pankki

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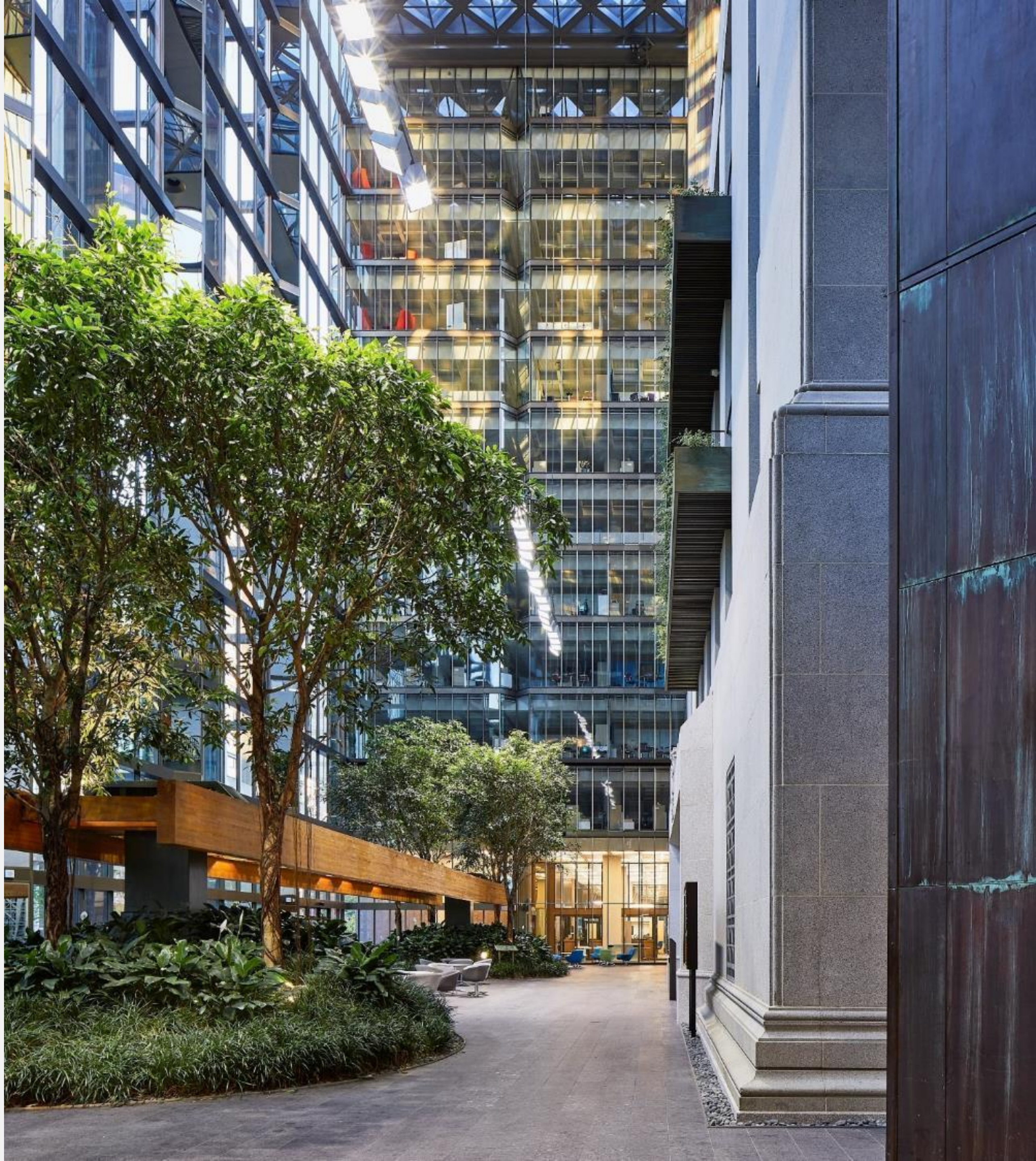


Motivation

- In Canada and the U.S., merchants generally do not differentiate prices based on payment methods.
- Merchants **pass through** their costs of accepting payment methods to all consumers, even though credit cards are more expensive for them to accept.
- Credit card transactions are **cross-subsidized** by lower-cost debit and cash payments. Card rewards and consumer fees paid to financial institutions may also generate **cross-subsidies**.
- Because higher-income consumers tend to use credit cards more often than lower-income consumers do, these cross-subsidies may lead to **regressive distributional effects**.

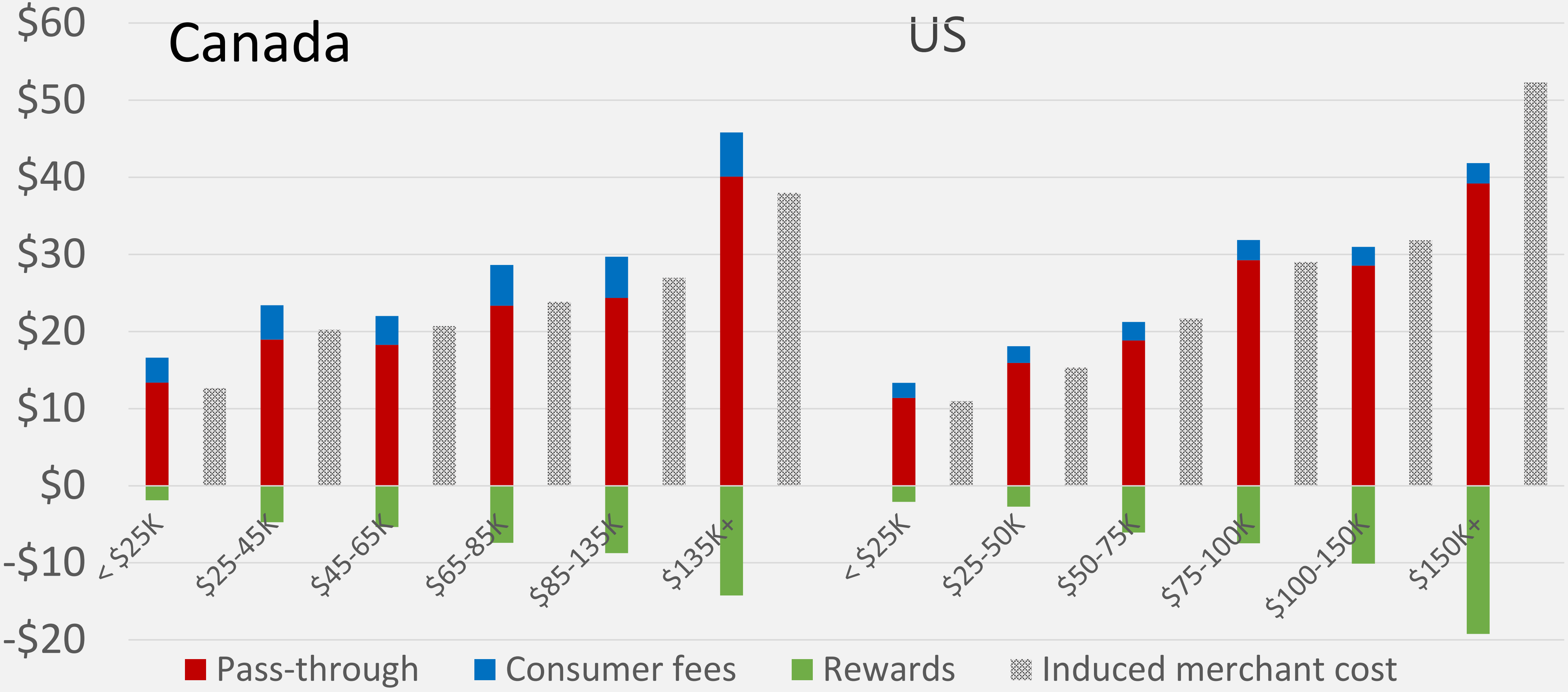
Method

- Using data from Canada and the U.S., we quantify the **net pecuniary cost** of using cash, credit cards, and debit cards to consumers in a range of **income cohorts**.
- **Net cost** includes:
  - the merchants' cost of accepting payments that is passed on to consumers,
  - fees paid to financial institutions,
  - rewards received from credit or debit card issuers.
- We examine whether low-income consumers incur a **disproportionally greater** net pecuniary cost relative to their transaction amount.

Key findings

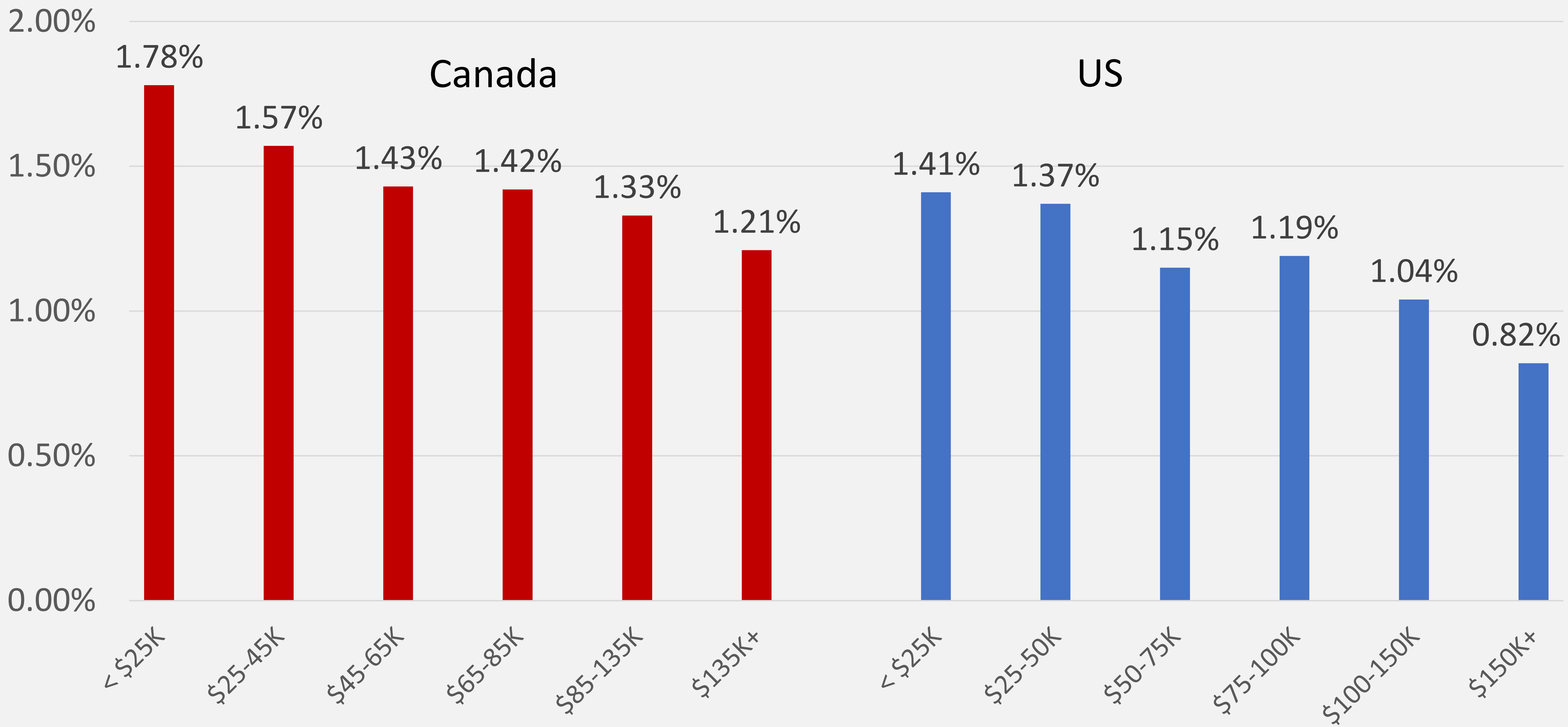
- In both Canada and the U.S., consumers in the **highest-income cohort** pay **the least** as a percentage of their transaction amount, while consumers in the **lowest-income** cohort pay **the most**.
  → suggests regressive distributional effects on consumers in both countries.
- Distributional effects occur through
  - Merchant cost pass-through leads to higher retail prices for all
  - Fees that are proportionally high for low-income consumers
  - Card rewards benefitting high-income consumers
- Regressive distributional effects are robust to specific quantitative assumptions.

Merchant pass-through contributes most of the pecuniary costs



Income categories are in local currencies; costs and rewards are in $US.

Per dollar net pecuniary cost is regressive



Ways to mitigate distributional effects

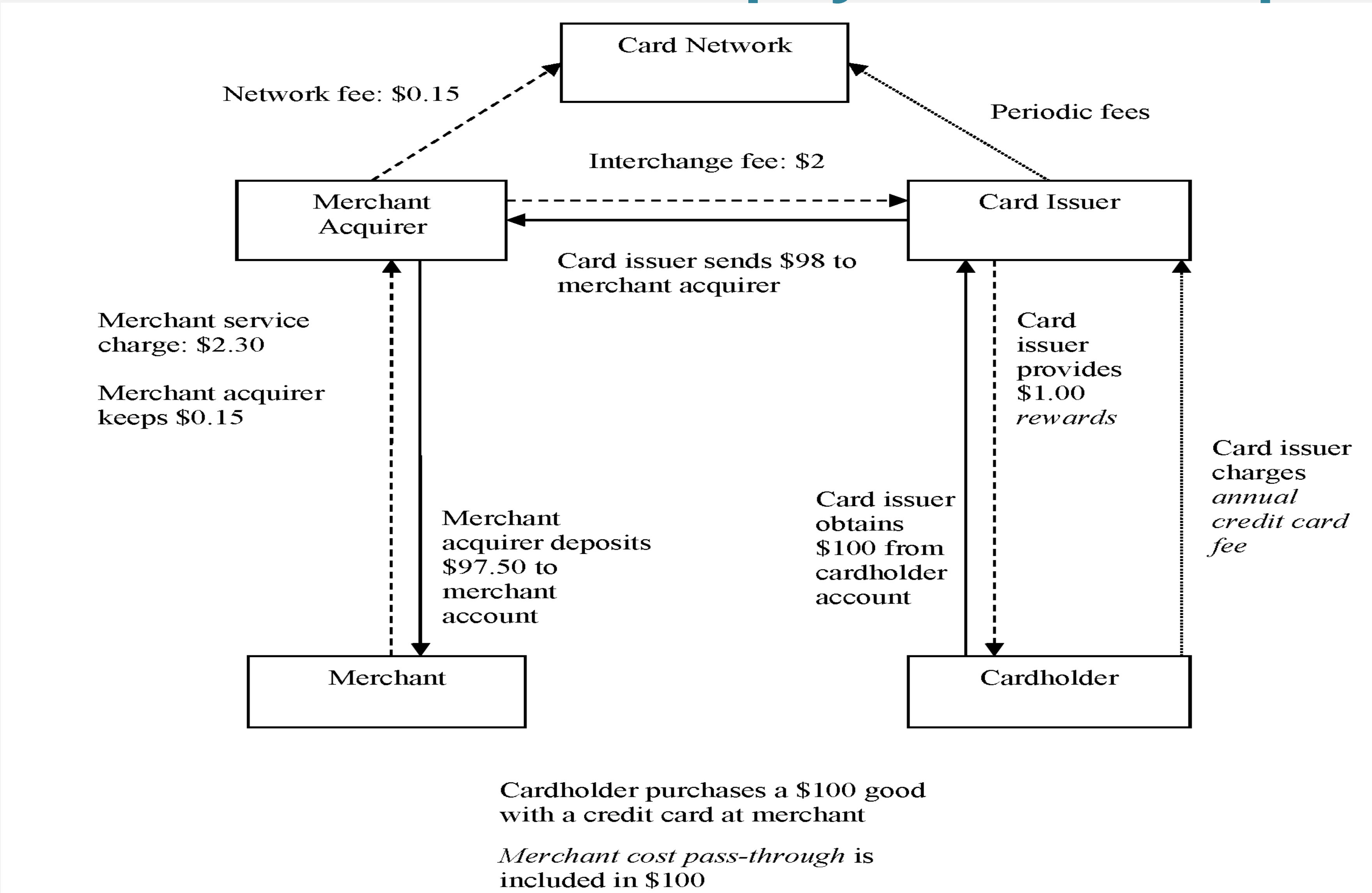
- Reducing credit card rewards along with interchange fees:
  - Lower income consumer might benefit
  - *Caveats: (i) Pass-through of interchange fees reduction assumed to be 100%.*
    (ii) Excludes subsequent effects and externalities generated by the two-sided credit card payment system.
- Changing the fee structure associated with bank accounts,
  - Reduce regressive effect stemming from account fees
  - *Caveats: (i) Same features are assumed for low-cost and typical bank accounts.*
    (ii) Excludes subsequent effects and externalities.
- Raising consumers' awareness of merchant cost pass-through.
  - Should lower merchant cost and hence cost of pass-through for all
  - *Caveat: We did not quantify the effect of awareness and steering.*

Concluding remarks

- Simple model to quantify net pecuniary costs shows that card payments induce regressive effects.
- Consumers have limited awareness that individual payment preferences generate costs <u>for all</u>.
- Changes to prices on both consumer and merchant sides or introduction of new payment features/methods can have unintended consequences.
- COVID-19 public health shock has shifted transactions to low contact sectors where cash is not accepted, increasing the significance of electronic payments.


Merci! Thank You! Kiitos!

Two-sided payment card platform



Note: Amounts and fee are illustrative.
This example displays a four-party card payment system where issuer, network and acquirer can be separate entities.