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Statement by
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Member, Board of Governors of the Federal Reserve System
before the
Subcommittee on Consumer Affairs and Coinage
Committee on Banking, Finance and Urban Affairs
United States House of Representatives
March 27, 1984
on
Cash Discounts and Surcharges
under
the Truth in Lending Act

I am pleased to appear before you this morning to present the views of the Board of Governors on the issue of whether the Truth in Lending Act should prohibit merchants from charging higher prices to credit card purchasers than to cash purchasers through the use of a "surcharge."

As you know, the purpose of the Truth in Lending law, which was passed in 1968, is to provide for a uniform disclosure of the cost of credit to consumers through the identified "finance charge" and "annual percentage rate." As a result, the act originally required that any differential between the price charged in a cash transaction and that charged in a credit transaction be treated as a cost of credit and included in the finance charge and annual percentage rate.

This requirement, as well as state disclosure and usury laws, however, was viewed in subsequent years as an obstacle to merchants wishing to implement two-tier pricing systems for cash and credit card customers -- that is, establishing two prices for property or services, a lower price for customers paying cash and a higher price for customers paying with a credit card. Consumer groups argued that the fee imposed on merchants by credit card companies was being passed on in higher prices to all customers.^{1/} As a result, it was argued that cash customers were being forced to subsidize credit customers when they were required to pay the same price for an item. Two-tier pricing systems were thus viewed as potentially beneficial to consumers as a means of eliminating the subsidy.

^{1/} The charge assessed by a credit card company on a merchant's credit card transactions is often referred to as the "merchant discount." If a merchant accepts a credit card for a \$100 purchase, for example, the merchant might be assessed a three percent fee, thus receiving only \$97 when the transaction is processed by the credit card company.

Congress responded to this concern and sought to eliminate this subsidy by removing the Truth in Lending and state law obstacles to merchants offering lower prices to cash customers. It amended the federal act in 1974 to provide that discounts for cash need not be considered finance charges for purposes of Truth in Lending. There was, however, a great deal of uncertainty following Congress' action as to whether it intended to permit additions to prices for credit card customers (surcharges) as well as reductions in prices for cash customers (discounts). In response, Congress in 1976 prohibited the imposition of surcharges -- that is, adding an amount to the regular price of an item when it was sold to credit card customers.^{2/} At the same time, Congress responded to the concern that state disclosure and usury laws presented an obstacle to discount programs by preempting them to the extent those laws treated discounts as finance charges.

However, because of some uncertainty as to the effect of the surcharge prohibition, it was originally scheduled to expire on February 27, 1979. Subsequently, the ban was extended until February 27, 1984. The principal reason for the temporary nature of the surcharge prohibition was to allow Congress to study the issue more thoroughly. It wanted to determine whether there is, in fact, a higher cost associated with the use of credit cards; whether cash customers do, as a result, subsidize credit customers; and whether it is necessary to allow surcharges as well as discounts in order to

^{2/} In amending the act Congress defined a discount as a reduction in the regular price and a surcharge as an addition to the regular price. The "regular price" was not defined, however. In order to allow merchants to determine whether their programs involved discounts or surcharges, the Board by regulation defined "regular price." This definition was made part of the act in 1981.

eliminate any subsidization. When the prohibition was last extended in 1981, the Board was directed to prepare a report on the effects of credit cards so that Congress would have a basis for making a permanent decision regarding surcharges. The report was to discuss the impact of credit cards on the costs that merchants incur, on the pricing of goods and services, and on retail sales volume.

The Board submitted its report in July 1983. Appendix A contains a more detailed summary of the results, but these are the main findings:

- The costs to retailers of credit card transactions (including point-of-sale, security-related, and financial costs) are higher than the costs for other types of transactions. The extra cost is about 2 to 3 percent of the transaction amount.
- There is little evidence that credit card usage increases overall retail sales volume. Since credit cards are so widely accepted, retailers as a whole do not recover the added cost of credit card transactions through increased sales.
- The extra cost of credit card transactions (to the extent it is not recovered directly from credit card users) is reflected in retail prices. It appears that on average the price of a given item is increased by something less than 1 percent.
- About 25 percent of gasoline stations and 6 percent of other retailers offer discounts. Approximately 40 percent of all retailers surveyed believed that discounts for cash are "a good idea."

In finding that credit card transactions cost most retailers more than cash or check transactions, and that the additional cost is generally not offset by higher sales volume but is reflected in the price level, the report supports the conclusion that cash buyers, at least to some extent, subsidize credit card users when all customers pay the same price.

The finding that credit card transactions cost more than cash or check transactions is based upon a survey of retailers about the relative

costs associated with cash, check, and credit card transactions, as well as a review of other studies dealing with the costs of various means of payment. Two of the other studies, one by Payment Systems, Inc. (PSI)^{3/} and one by R. Grant,^{4/} could be viewed as indicating that credit card transactions do not cost more than cash and check transactions. We believe, however, that drawing this conclusion from these studies would be incorrect because of the limited cost factors considered in one of the studies and the assumptions made in the other. The PSI study looked at only point of sale and other handling costs among the three means of payment -- cash, check, and credit card -- and did not consider other costs associated with the transactions, most notably the merchant discount in credit card transactions. The Grant study, in order to conclude that the additional cost of credit card transactions was offset by a reduction in fixed costs due to increased sales, assumed that credit cards resulted in a 20-30 percent increase in incremental sales revenues, an assumption that we find without basis and a position with which we disagree in our study.

The Board's study found that the additional cost of credit card transactions was between 2 and 3 percent of the transaction amount, and estimates the typical size of the subsidy to be between 1/2 percent and 1-1/4 percent of the total price. These findings appear to confirm the belief held by Congress in 1974 that cash customers subsidize credit card customers. At the same time, the size of the subsidy may be smaller than

^{3/} Payment Systems, Inc., Cost of Cash: A Strategic Analysis, Atlanta, 1981.

^{4/} Grant, Robert M., "Transaction Costs to Retailers of Different Methods of Payment. Result of a Pilot Study." Processed. Report prepared at The City University, London, 1982.

many people had assumed, since the additional cost of credit card transactions is spread over all sales -- both cash and credit. The relatively small size of the subsidy, as a percent of a particular item's price, may help to explain why few retailers have seen fit to adopt two-tier pricing systems; at the same time, the total amount of the additional cost due to credit card transactions and the total amount of the subsidy, in the economy as a whole, is probably large.

Of the many options available to Congress, two are currently being considered in pending bills. One bill, H.R. 5026, would make the surcharge prohibition permanent, necessitating that two-tier pricing be accomplished through discounts for cash. Under this approach, existing discount programs would be expected to continue, but there would be little reason to expect more to be offered in the future. The other bill, S. 2336, would discontinue the characterization of certain price differences as "discounts" and others as "surcharges." At the same time, by excluding the price differences from treatment as a cost of credit under federal and state laws, it would continue to encourage merchants to offer price differences to induce payment by cash instead of by credit card. The Board supports this approach which, by no longer distinguishing between a "discount" and a "surcharge," might promote additional two-tier pricing.

Our position is based on the proposition that discounts and surcharges are fundamentally equivalent, as well as on a number of practical considerations. First, while advocates of discounts have claimed that discount programs result only in price reductions for cash buyers, without penalizing credit card users, economic reality is such that prices generally will be restructured so that the "new" credit price is above -- and the discounted cash price only somewhat below -- the "old" single price. The Board's study indicates that if discount programs are to be economically feasible, most are likely to involve some

increase in the price, from which discounts to cash customers are calculated. In fact, two-tier pricing through discounts ordinarily would result in essentially the same level of credit and cash prices as would a surcharge program. (This is discussed in more detail in Appendix B.)

Second, allowing two alternative methods of pricing may provide merchants the flexibility they need to offer more of the two-tier pricing that Congress is trying to encourage. Although 40 percent of the retailers surveyed by the Board considered cash discounts a "good idea," only 6 percent actually offered them. This low figure may mean that merchants find discount programs too difficult to administer. Another possible explanation is that the similarity between discounts and surcharges has caused confusion among merchants about the difference between a permissible discount and an illegal surcharge -- as evidenced by many inquiries the Board has received about the distinction. This uncertainty about the law may have discouraged merchants from offering discounts. If the lack of two-tier pricing is related to either or both of these factors, then there is some hope that permitting both pricing schemes might promote the result Congress originally hoped to achieve.

A third consideration concerns the claim made by some opponents of surcharges that allowing both types of two-tier pricing will lead to consumer confusion in a marketplace where some merchants offer discounts and others impose surcharges. While the possibility of some initial confusion certainly exists (much like that which accompanied the introduction of discount programs at service stations), we do not think the problem would be major since merchants would still be required to disclose their policies. In addition, the Board believes that competition and the merchants' desire for customer goodwill would lead them to make clear to their customers what their pricing practices are.

Furthermore, there is at least one type of problem with discount programs that would not exist with surcharges. Some reports indicate that cash customers have not always received the discounts to which they were entitled; this has occurred, for example, where customers believed that the posted price reflected the discount, when in fact it did not.

Although the Board believes that merchants should be free to charge different prices without having to characterize the difference as a cash discount instead of a surcharge (a requirement imposed by the previous ban on surcharges), we believe that the limitations found in the Senate bill are appropriate. First, we agree that, in any two-tier pricing system, the price difference that is excluded from truth in lending requirements and state disclosure and usury laws should be limited to 5 percent of the cash price of the property or service. Any difference in the price charged to cash customers and to credit customers is a cost of credit and normally would be viewed as a finance charge. In the case of a price difference to induce customers to pay by cash instead by credit card, however, Congress chose to make an exception to encourage merchants to eliminate the cash customers' subsidization of credit card customers, even though it sacrificed some accuracy in the credit cost disclosures and in the protection offered by state usury laws. Since this provision involves a trade-off with the goals of the Truth in Lending Act and state laws, we think some limits are appropriate. Furthermore, we think the 5 percent limit would not keep merchants from offering price differences related to the extra cost of credit card transactions. The Board's study indicates that the fee imposed by credit card companies on merchants averages 3.1 percent (with an average of 4.1 percent for small businesses), well within the 5 percent limit. In addition, most cash discounts now being offered are in the neighborhood of 3 to 5 percent.

Second, we agree that the two-tier pricing provision should be limited to credit cards as it is in the Senate bill. The purpose of the original exception, in fact the only focus of the discussions over the years, was to provide a means to remove the extra cost of credit card transactions from the price charged to the cash customer. However, in 1981 Congress changed the language of the act to provide special treatment for discounts not only in credit card transactions, but in all open-end credit transactions. The Board believes that since open-end credit transactions not involving a credit card do not generally result in a "merchant discount," this may have been an unwarranted extension of the provision and could further undercut the accuracy of the Truth in Lending disclosures and the effectiveness of state laws.

I appreciate the opportunity to address the subcommittee and hope that our testimony will be of assistance in your efforts to deal with this difficult question.

APPENDIX A

SUMMARY OF FEDERAL RESERVE BOARD'S CREDIT CARD STUDY*/

The fundamental thesis underlying the Cash Discount Act is that credit card transactions are more costly to retailers than cash or check transactions, and that the higher costs of credit cards are incorporated in the prices of goods and services paid by all customers, resulting in a subsidy of credit buyers by cash purchasers.

The most basic challenge to this view would be the assertion that, properly measured, transactions costs for credit cards do not differ from other means of payment, or that the magnitude of difference is negligible. Another counter-argument sometimes proposed to the subsidy thesis is that credit cards generate incremental sales for retailers, so that the additional profits thereby attributable to cards eliminate any need to recover the cost of credit cards in prices of goods and services. The Board's study addressed these issues, and also examined the current practices and attitudes of retailers toward offering discounts for cash.

Following a brief overview in Chapter 2 of the study describing the types of credit cards available and the incidence of their use among households, Chapter 3 examined the broad question of the impact of credit cards on sales of retailers. Many observers would argue that because consumers are enabled by credit cards to spend beyond the immediate limits of cash or checking account balances, they are more likely to make ill-considered purchases and, in general, to spend more and save less than they would in the absence of credit cards.

This idea was examined in two ways: first, through a survey of households on "impulse" purchases transacted by credit cards; and second, by

*/ "Credit Cards in the U.S. Economy: Their Impact on Costs, Prices, and Retail Sales," July 27, 1983.

a review of available research on the link between credit cards and aggregate spending, on the grounds that any broad increase in spending induced by credit cards would be expected to boost aggregate consumption and to reduce the aggregate saving rate. However, neither the household survey nor the macroeconomic studies suggested that any strong, consistent relationship exists between credit cards and incremental sales among retailers as a group.^{1/} The survey found that many unplanned purchases were transacted by cash, and that many of those transacted through credit cards would likely have been undertaken even without access to a credit card. The limited amount of macroeconomic research available has failed to establish any measurable impact of credit cards on the aggregate saving rate.

Chapter 4 examined the costs associated with credit cards and other means of payment, and summarized a number of relevant studies. It also reported on the results of a survey of retailers conducted during the spring of 1983 concerning their perceptions of the relative costs of credit cards, cash, and checks. The weight of the evidence from the survey and other studies was that total net costs to retailers associated with credit cards -- including point-of-sale, security-related, and financial costs -- were in fact higher than for other types of transactions, typically by about 2 to 3 percent of the transaction amount, a figure which roughly corresponds to the average factoring or servicing fee paid by merchants to issuers of third-party credit cards (or the net credit department deficits of retailers that issue their own credit cards). For most

^{1/} Whether card-honoring retailers attract sales from other retailers who don't accept credit cards is treated as a minor issue, in view of the widespread acceptance of credit cards. Unless industry-wide sales are increased, gains and losses from credit card sales will net out among retailers, yielding no net additional revenue to offset the higher costs of credit cards.

retailers, the costs of check transactions appeared to be smaller than for credit cards, and either about the same or larger than for cash. Large retailers were more likely than small retailers to rate both checks and credit cards as more costly than cash.

In Chapter 5, the issue of whether the higher costs of credit cards are included in retail prices was discussed. From a microeconomic perspective, it was concluded that prices in the long run would reflect all such costs that were not recovered directly from credit card users, but that the size of the price effect would be small. In total, the need to cover credit-related costs would likely boost the price of a given item by less than 1 percent. This minimal impact owes in part to the relatively small share of sales transacted by credit cards -- around 15 percent through third-party cards in the areas of general merchandising under study. If an added cost of 3 percent occurs on 15 percent of sales, the spreading of that cost over all sales would boost prices by just under 1/2 percent ($.03 \times .15 = .0045$).

From a macroeconomic perspective, credit cards could potentially affect economic activity by altering the aggregate propensity to consume and/or the transactions demand for money. Some impact on the equilibrium level of prices during a period of adjustment to the introduction of credit cards was held possible, but available evidence suggested that such an effect would be small and mostly irrelevant to the long-run processes of economic growth or inflation.

From Chapters 3 through 5, it could be concluded that credit card transactions cost most retailers more than cash (or check) transactions, and that this cost is not offset by higher retail sales volume, but is reflected in the level of prices. As a result it could be said that cash buyers, at least to some extent, subsidize credit card users by paying identical prices.

Chapter 6 raised two possible methods of minimizing the subsidy: (1) removal of government-imposed artificial barriers to coverage of credit card costs via finance charges and other user fees, and (2) establishment of a two-tier price structure involving discounts for cash or surcharges for credit. Because of legislative changes, both methods have become more accessible in the past few years.

Revisions in state usury laws and other statutes have enabled card issuers to shift more of the cost of credit cards onto users recently. The Cash Discount Acts have encouraged two-tier pricing, but adoption of such pricing appears feasible for most retailers only if they simultaneously raise the base price from which discounts would be calculated, so that the "new" credit price is above -- and the discounted cash price only somewhat below -- the "old" single price.^{2/} This conclusion is based on results from surveys of consumer reaction to actual two-tier pricing of gasoline and to hypothetical discounts for cash on durable goods and clothing, as well as implications from the findings on costs in Chapter 4.

A polling of retailers on their current practices and attitudes toward discounts for cash, reported in Chapter 6, found that in the spring of 1983 cash discounts were typically the exception rather than the rule for types of business likely to accept credit cards in addition to other means of payment. About 25 percent of gasoline stations and 6 percent of other retailers offered discounts, with around 40 percent of all retailers surveyed describing discounts for cash as "a good idea." About three out of every ten retailers thought that surcharges for credit constituted a better approach to two-tier pricing than discounts for cash; 70 percent thought surcharges an inferior approach.

^{2/} Two-tier pricing through surcharges for credit would ordinarily result in the same structure of credit and cash price as under a discount-for-cash approach.

APPENDIX B

HYPOTHETICAL EXAMPLE OF TWO-TIER PRICING OF GASOLINE

This Appendix presents a hypothetical example of gasoline pricing before and after adoption of a discount-for-cash program; the principles involved would apply as well to other retailing situations. The example assumes that there are no shifts in underlying wholesale gasoline prices, that sales volume remains constant, and that the gasoline retailer has an objective of maintaining a constant level of profits.^{1/} The purpose of the example is to indicate the relationship that could be expected between a former single price for gasoline and a new two-tier set of prices, using estimates about certain aspects of buyer behavior that were discussed in Chapter 6, section 2, of the Board's Report to Congress.

The example, shown in table B.1, is constructed with 100 customers each buying one gallon of gasoline. Drawing on the results of a household survey of gasoline purchase experience, the assumption is made that about 40 customers would use credit cards and 60 would pay in cash in the absence of a discount offer. For sake of illustration, it is assumed that gross receipts of \$120 would cover all costs, including credit card costs, and yield the gasoline seller some desired level of profits. Obviously, under a single-price system, the retail price of a gallon of gas would be \$1.20 to each customer.

Introduction of a discount-for-cash policy complicates the price structure. In line with the discussion in Chapter 6 of the Report and

^{1/} It is recognized that the introduction of a discount-for-cash program may affect a station's volume of sales, at least at first. The station may hope to increase sales by attracting cash users away from competitors. But competitive response by other stations is likely to minimize any sales advantage initially accruing to a dealer that sets up a two-tier system. Unless two-tier pricing were to stimulate total industry-wide gasoline sales, it would be inappropriate to assume some permanent sales gain for any particular retailer.

statistics presented there (in table 6.2), when a discount is offered, the proportions of cash and credit buyers are assumed to shift from .60 and .40, respectively, to .75 and .25. In the present example, then, 75 persons would buy for cash and 25 would use a credit card under two-tier pricing, for a net shift of 15 customers from credit to cash. Since this shift would reduce the seller's cost of carrying receivables, the gross revenue needed to maintain level profits would drop by 15 times the per gallon cost saving. In the example, a credit-handling cost of 3 cents per gallon of gas sold on credit is used, which approximates the cost estimated by several major gasoline companies. By influencing 15 customers to switch from credit card to cash, the gas station in the example could save 45 cents in credit servicing costs, thus reducing the level of gross revenues needed to maintain constant profits to \$119.55 from \$120.

Assuming that the cash price and credit price would be set to differ by the amount of credit-related costs per gallon, it can be calculated (as shown in table B.1) that the gasoline seller would need to price gas at \$1.188 for cash sales and \$1.218 for credit sales.^{2/} Because the lower price for cash must be offered to those who would pay cash anyway, the cash price cannot be reduced from the old \$1.20 price by the full amount of the per gallon cost of credit. Instead, the two-tier price points would bracket the old single price point.

^{2/} Alternatively, rather than assuming a price differential equal to the difference in cost between credit card and cash transactions, then solving for the two prices, one could assume the credit price to be set equal to the price that would be charged in a one-tier system (\$1.20 in this example), then solve the equations for the cash price. Under this approach, it can be calculated that, given the credit price of \$1.20 in the two-tier system, the cash price would have to be at least \$1.194 to maintain the target level of profits.

Retail gasoline prices in the real world often fluctuate a few cents from week to week. Thus it is difficult to judge how closely an actual station's two-tier price structure vis-a-vis an alternative single price policy might compare with the example sketched here. However, as noted, values of the key variables in the example were chosen -- based on survey results -- to realistically reflect conditions faced by typical gasoline retailers. Moreover, as further calculations under alternative assumptions would show, the implications of the example do not depend narrowly on the specific values of the variables used. That is, under widely different customer purchasing habits, the new two-tier price schedule would still bracket the old one-tier price. For instance, if it were assumed that as many as 60 percent (instead of 40 percent) of the customers would use credit cards in a single-price system, and that only 20 percent would use credit cards in a two-tier system,^{3/} the "equal-profit" prices would be \$1.182 for cash and \$1.212 for credit, compared with the one-tier price of \$1.20.

^{3/} In other words, 40 percent of the total customer base would switch from credit card to cash in this alternative, compared with 15 percent who switched in the original example.

TABLE B.1

HYPOTHETICAL GASOLINE PRICING WITH CONSTANT PROFITS
UNDER ONE-TIER AND TWO-TIER PRICING SCHEMES

<u>Single-price case:</u>		<u>Two-tier pricing:</u>
$aX + bY = R$	revenue function	$(a+s) X + (b-s) Y = R - cs$
$X - Y = 0$	price structure	$X = Y - c$

calculations:

$$\begin{array}{r} 60 X + 40Y = \$120 \\ X - Y = 0 \\ \hline 100 X = \$120 \end{array}$$

$$\begin{array}{l} X = \$ 1.20 \\ Y = \$ 1.20 \end{array}$$

$$\begin{array}{r} (60+s)X + (40-s)Y = \$120 - \$.03s \\ X - Y = -c \\ \hline \end{array}$$

$$\begin{array}{r} 75 X + 25 Y = \$119.55 \\ X - Y = - \$.03 \\ \hline 100 X = \$118.80 \\ X = \$ 1.188 \\ Y = \$ 1.218 \end{array}$$

where: X = cash price
 Y = credit price
 a = number of customers per 100 that typically pays cash
 b = number of customers per 100 that typically uses credit card
 R = desired gross revenue for initial cash/credit sales mix
 s = number of customers that shifts to cash from credit
 c = cost of financing receivables per gallon of gas sold on credit

assumptions:

a = 60, b = 40
 R = \$120
 s = 15
 c = .03
 each customer buys one gallon of gas
