**Plastic Populism**

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The congressional stampede—incited by President Bush—to impose price controls on credit card interest rates is the latest example of a new bipartisan populism in American politics.  The idea is to beguile voters with the promise that the government can reduce the price of some widely used good or service.  Why price is increasing is a question almost never asked.

The answer is usually straightforward.  Relative prices increase because costs of supply increase, and supply costs increase as a result of quality improvements, changes in consumer demand, or legal developments (e.g. expanded tort liability).  Price controls cannot abolish these relationships.  What they can do, and have done in an unbroken string of policy failures stretching back dozens of centuries, is to cause inefficient repricing of uncontrolled terms of trade, reductions in the quantity and quality or supply, and arbitrary redistributions of income among consumers and producers.  The Senate’s credit card bill, which sets the maximum interest rate at four percentage points above the IRS’s charge on overdue taxes, fits the pattern perfectly.

The supply of consumer credit is today a highly competitive national market.  Thousands of banks, retailers, telephone companies, and others offer credit cards.  (It is the individual banks, not Visa and Mastercard, that set interest rates and other credit card terms.)  The behemoth of the credit card industry, Citicorp, holds about 4% of the consumer installment credit market, and only three other firms (Sears Roebuck, General Electric Capital and Chase Manhattan) hold as much as 1%.  There is not the remotest chance that any credit card issuer could set rates higher than its costs of service, or could permit its costs to escalate without suffering a disastrous loss of business.

**Only the Affluent**

Twenty years ago credit cards were generally available only to the affluent and could be used only in local markets or with a single retailer.  Young families and people of modest means were obliged to bear the costs of keeping relatively large amounts of cash on hand, and their borrowing was limited to finance companies, lay-away plans, pawnbrokers, or family and friends.

The now-ubiquitous credit card has changed all this.  It is as good as cash for purchases of a few thousand dollars at establishments everywhere in the nation; it permits nationwide telephone purchasing and reservations; it provides instant credit that may be drawn upon and repaid largely at the discretion of the borrower.  And it is available to essentially everyone who is not very poor and who is credit-worthy.  Substantially more than half of American households with annual incomes of $10,000 to $20,000 have a credit card.  Usage increases sharply at higher but still modest income levels.

These benefits would have been impossible before technological advances in data processing and communications, and related business advances in marketing  credit and managing credit risks.  Yet these advances, powerful as they were, would have led nowhere so long as state usury laws were in place.  Those laws generally capped interest rates at levels that made it worthwhile for banks, retailers and other lenders to lend only to low-risk local clients who had well-established credit records.

Fortunately, the Supreme Court held in 1978 (in *Marquette National Bank v. First of Omaha Service Corp.*) that interstate loans by nationally chartered banks are governed by the interest rate ceiling of the bank’s home state, not the borrower’s state—a decision that effectively opened the door to interstate consumer lending.  A year later South Dakota abolished its interest rate controls on consumer credit, and New York’s Citibank moved its credit card operations there and invaded regulated local credit markets from coast to coast with unregulated South Dakota credit.

Over the next five years, one-third of the states repealed their interest rate controls and another one-third substantially relaxed them.  The number of active U.S. Visa and MasterCard accounts grew by more that 40%.  A substantial share of the new accounts were working-class families, recent college graduates, and others unable to obtain credit cards before.

In 1986, I was commissioned by the American Bankers Association to do a study of the likely consequences of credit card interest rate controls.  Then as now, short-term commercial rates had been falling while credit card rates had been holding steady at a higher level.  Congressional wrath was focused, of course, on the highest credit card rates, which were being charged by banks in states that had repealed their rate controls.  "If Arkansas [the strictest control state] can hold down credit card charges for the benefit of its citizens," the congressional proponents asked, "why shouldn’t we provide the same benefits for everyone?"

My research revealed, however, that these benefits were an illusion.  Consumers themselves—the putative beneficiaries of rate controls—had been flocking by the millions to unregulated credit, and had been doing so precisely at a time (like the present) when falling commercial interest rates were widening the spread between regulated and unregulated consumer rates.

From 1980 through mid-1985, when the quantity of U.S. consumer credit on Visa cards more than doubled, banks in states with no rate controls increased their Visa business more than 27% faster than the national average, mostly by soliciting new accounts among riskier demographic groups, such as students and blue collar workers with no credit history.  During the same period, banks in states with strict controls lost 23% of the national Visa market.  In general, banks in states with the strictest controls fell furthest behind the national trend.

Back in 1986, many bankers assumed that rate controls would lead to extensive "repricing"—as banks compensated for lower interest rates by raising annual fees, eliminating initial interest-free periods on purchase balances, and making other adjustments.  The evidence suggested, however, that repricing opportunities were limited, and that the dominant effect of controls would be a contraction in the availability of credit, and its restriction to local markets and more affluent groups.

It is true that interest rates on credit cards are higher than commercial rates.  This should not be a surprise, because credit card credit is more costly to provide:  Administrative costs constitute a larger share of the costs of supplying credit cards than the costs of the funds issuers are lending.  But the extent of the rate difference has been exaggerated in almost all accounts of the credit card debate. When one takes account of the initial one-month “free period” on most credit cards and the average time period in which credit balances are paid off, the effective interest rates cardholders are paying are generally several points lower than then official rates.

There is another way in which the congressionally cited interest rates are an illusion:  The congressmen advocating controls quote either the highest rates or volume-weighted averages of the rates charged by numerous banks and other suppliers.  In fact, rates have become more dispersed over time as the variety of card programs has increased.  Some of the largest card issuers, such as Chase and Citicorp, have successfully specialized in marketing cards to younger, less well-off and riskier consumers who were not in the market five or ten years ago; as a result their current rates are higher than average.

The consumer would not be the only victim of interest rate controls.  Banks and other credit card issuers would be seriously damaged too:  They would lost business, and their facilities devoted to mass consumer credit would lose value in the same manner as rent-controlled apartment buildings. But Congress has made it plain that it is indifferent to the decline of the American banking industry. As a result, banking executives are quite properly emphasizing the consumer’s side of the issue, warning that controls would lead to a prompt and substantial restriction in the availability of credit cards and the size of credit lines, and a consequent drop in retail spending.

**Not Evenly Distributing**

Congress should also reflect that the restriction of credit would not be evenly distributed.  The contraction in consumer credit would not be some kind of aggregate tightening affecting everyone a little bit.  Rather it would be highly focused on young and working-class families.

In the late 1970s and early 1980s Democrats and Republicans joined forces to enact a series of sweeping measures deregulating large sectors of the U.S. economy.  It was a marvelous era, not only because of the economic benefits it provided by because it drew upon and strengthened the noblest traditions of each party—the Republicans’ concern for individual liberty and economic growth, and the Democrats’ concern for improving the welfare of average citizens.  No doubt it was too good to last. Still, it is disheartening to see the situation not only ended but reversed, with the parties offering tawdry appeals such as consumer price controls, thus compromising their commitments to liberty on the one hand and equality on the other.