

Credit card surcharging: what is it and how is it changing?

Written by The Conversation

Credit card surcharging is in the news. Apparently consumers are going to benefit by [new surcharge limits](#) that will be imposed on retailers. But what is surcharging? And why does it need limits? And is surcharging a [good or a bad](#) thing for customers?

What is a credit card surcharge?

When you buy something from a retailer, you usually have a choice of payment instruments. You can pay by cash, direct debit (EFTPOS), credit card, or sometimes more exotic options like BPAY or PayPal.

These different payment options have different costs for the retailer. When you pay by credit card the retailer pays its bank a percentage fee. This 'merchant service fee' can vary by card. It is often higher for American Express than for Visa or MasterCard. The fee also varies between retailers.

It generally costs retailers more when you pay by credit card than use, say, direct debit. As the Reserve Bank of Australia (RBA) notes, the "main factor here is the higher merchant service fees". (See "[Payment costs in Australia](#)").

If the retailer cannot surcharge (i.e. it has to set the same price regardless of how a customer pays) then it will recover the cost of payments through the price. Put another way, the retailer's price will include a margin to cover the 'average' payment cost. This means that if you use a high cost payment instrument, like a credit card, you pay the same as someone who uses a low cost payment instrument, like a debit card. So without surcharging, credit card customers are effectively being 'cross subsidised' by customers who don't use credit cards. The non-credit card-customers save the retailer money, but the customers do not get any benefit from this.

Surcharging is where the retailer adds on an extra fee to a credit card customer. This means that a credit card customer will pay more than other customers for the same goods or services. But remember, the credit card customer also costs the retailer more than other customers.

Have we always had credit card surcharging?

No. [Prior to 2004](#) , the major credit card companies prohibited surcharging.

In 2003, the RBA introduced a series of payment system reforms. These included the elimination of no-surcharge rules. This meant that retailers could recover the cost of accepting a credit card from the customer who chose to use the credit card. But there was no limit on the size of surcharge that a retailer could set.

The RBA reforms, including the elimination of no-surcharge rules, have been followed around the world ([see Box B](#)).

What is the economic logic behind surcharging?

Under a no-surcharge rule, there will [be excessive use of credit cards](#) . Customers will choose to use a credit card even when the total cost of using that card (including the cost to the retailer) exceeds the benefit to the customer. This is because the customer doesn't face the true cost of using the credit card. The no-surcharge rule ensures the cost is 'shared' with other customers who do not pay by credit card.

Surcharging changes this. Instead of spreading the credit card cost among all customers, a surcharge means that the customer who uses the credit card (and creates the cost for the retailer) also pays the extra cost.

Because credit cards are relatively expensive payment instruments, forcing consumers to face the true cost of credit cards will discourage them from using these cards. Consumers will substitute to less costly payment instruments like direct debit.

[RBA data](#) suggests that this substitution has happened. Since 2004 the use of both credit and debit cards has significantly increased. But before 2004 they increased at about the same rate. Since 2004 the use of debit cards has grown significantly faster than credit cards. While other factors may also have influenced this change (e.g. Visa and MasterCard both introduced debit cards) it looks like surcharging did have its desired effect.

The no-surcharge rule is also unfair

Why?

Well think about the reward points or frequent flyer miles or other benefits you get when you use your credit card. The banks do not give you these because they like you. They make profits from the fees they receive every time you use your credit card. And under a no-surcharge rule, these fees get hidden in the retail price and paid by all consumers. So under a no-surcharge rule, customers who pay by direct debit, cash or some other non-credit means, also pay for your reward points. Credit card users may like to force other consumers to pay for their reward points. But I doubt that such a hidden cross subsidy passes too many people's concept of fairness.

Hate surcharging?

If you dislike credit card surcharging, you are not alone. A [survey by Choice](#) for Fair Trading NSW found that 68% of respondents "believe that retailers and other businesses should not be allowed to charge customers extra when they pay with their credit card".

And if you use a credit card a lot, you should hate surcharging. Banning surcharging means that every time you use your credit card you get a little subsidy from customers who do not use credit cards. These subsidies add up – partially as reward points!

People also hate surcharging because it looks like a new fee. It isn't. Surcharging just makes the cost of using a credit card transparent. The costs have always been there. But without surcharging it is hidden in the price.

People dislike surcharges because they are not sure if the charge is 'fair'. I suspect that more people would put up with a surcharge on a credit card if they really knew that it reflected the actual extra cost to the retailer. However, how do we know the retailer isn't overcharging us through the surcharge?

And the credit card companies hate surcharging, because it means they make less profit.

Are surcharges excessive?

Both the [RBA data](#) and Choice report show that some surcharges appear to be greater than the extra cost to the retailer. In economic-speak, the retailer is price discriminating against the credit card customer, by adding a bit extra into the surcharge above the retailer's costs.

The fact that surcharging on credit cards could lead to price discrimination was always a possibility. I [did research on this](#) with Joshua Gans in 2002.

In March 2013 the RBA tightened the rules on surcharging to try and limit excessive surcharging. But, as the RBA recognises, the problem of excessive surcharging has not gone away.

What is the Murray Recommendation and will it work?

[Recommendation 17](#) from the Financial System Inquiry (the Murray report) states that the government should "Improve surcharging regulation by expanding its application and ensuring customers using lower-cost payment methods cannot be over-surcharged by allowing more prescriptive limits on surcharging".

The [government response](#) is:

"We will increase the efficiency of the payments system and ensure it achieves fairer outcomes for consumers, merchants and system providers by phasing in a legislated ban on excessive card surcharges. The ACCC will be responsible for enforcing these rules.

The Payments System Board will pursue policies to address problems with interchange fees and provide clarity around what constitutes excessive customer surcharges on card payments. The Payments System Board released a consultation paper on these issues in March".

So we need to wait to see the Payment System Board investigation and the resulting legislation

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to know the final answer.

Disclosure

Stephen King has provided advice on credit cards to the NAB and has provided advice on competition issues to Visa.

Read more <http://theconversation.com/credit-card-surcharging-what-is-it-and-how-is-it-changing-49511>