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Behavioral Law & Economics Goes to Court

The Fundamental Flaws in the Behavioral Law & Economics Arguments Against No-Surcharge Laws

Todd J. Zywicki, Geoffrey A. Manne & Kristian Stout[*]

Summary

During the past decade, academics—predominantly scholars of behavioral law and economics—have increasingly turned to the claimed insights of behavioral economics in order to craft novel policy proposals in many fields, most significantly consumer credit regulation. Over the same period, these ideas have also gained traction with policymakers, resulting in a variety of legislative efforts, such as the creation of the Consumer Financial Protection Bureau. Most recently, the efforts of behavioral law and economics scholars have been directed toward challenging a number of state laws that regulate retailers' use of surcharge fees for consumer credit card payments. In part as a result of these efforts, the issue has come before multiple courts, with varying outcomes.

In 2016 the issue reached the Supreme Court, which granted *certiorari* in *Expressions Hair Design v. New York* for the October 2016 term. The case, which centers on a decades-old New York state law that prohibits merchants from imposing surcharge fees for credit card purchases, represents the first major effort to ground

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[*] Todd J. Zywicki is George Mason University Foundation Professor of Law at Antonin Scalia Law School, George Mason University; Executive Director of the Law & Economics Center; and Senior Scholar at the International Center for Law & Economics (ICLE). Geoffrey A. Manne is the founder and Executive Director of ICLE, a nonprofit, nonpartisan research center based in Portland, OR. Kristian Stout is Associate Director for Innovation Policy at ICLE. ICLE has received financial support from numerous companies, organizations and individuals, including both payment card networks and merchants. Unless otherwise noted, all ICLE support is in the form of unrestricted, general support. The ideas expressed here are the authors' own and do not necessarily reflect the views of ICLE's advisors, affiliates or supporters. Please contact the authors with questions or comments at icle@laweconcenter.org.

constitutional law (here, First Amendment law) in the claims of behavioral economics.

In this article we examine the merits of that effort. Claims about the real-world application of behavioral economic theories should not be uncritically accepted—especially when advanced to challenge a state's commercial regulation on constitutional grounds. And courts should be especially careful before relying on such claims where the available evidence fails to support them, where the underlying theories are so poorly developed that they have actually been employed elsewhere to support precisely *opposite* arguments, and where alternative theories grounded in more traditional economic reasoning are consistent with both the history of the challenged laws and the evidence of actual consumer behavior.

The Petitioners in the case (five New York businesses) and their *amici* (scholars of both behavioral law and economics and First Amendment law) argue that New York's ban on surcharge fees but not discounts for cash payments violates the free speech clause of the First Amendment. The argument relies on a claim derived from behavioral economics: namely, that a surcharge and a discount are mathematically equivalent, but that, because of behavioral biases, a price adjustment *framed* as a surcharge is more effective than one framed as a discount in inducing customers to pay with cash in lieu of credit. Because, Petitioners and *amici* claim, the only difference between the two is how they are *labeled*, the prohibition on surcharging is an impermissible restriction on commercial speech (and not a permissible regulation of conduct).

Assessing the merits of the underlying economic arguments (but not the ultimate First Amendment claim), we conclude that, in this case, neither the behavioral economic theory, nor the evidence adduced to support it, justifies the Petitioners' claims. The indeterminacy of the behavioral economics underlying the claims makes for a behavioral law and economics "just-so story"—an unsupported hypothesis about the relative effect of surcharges and discounts on consumer behavior adduced to achieve a desired legal result, but that happens to lack any empirical support. And not only does the evidence not *support* the contention that consumer welfare is increased by permitting card surcharge fees, it strongly suggests that, in fact, consumer welfare would be *harmed* by such fees, as they expose consumers to potential opportunistic holdup and rent extraction.

As far as we know, this is the first time the Supreme Court has been expressly asked to consider arguments rooted in behavioral law and economics in reaching its decision. It should decline the offer.

Introduction

Should merchants be permitted to charge a consumer a higher price if the consumer wants to pay with a debit or credit card than if she uses cash or the retailer's proprietary credit card? In 2016 the Supreme Court granted *certiorari* in the case of *Expressions Hair Design v. New York*,[1] a challenge brought by New York retailers to strike down a state law that prohibits merchants from imposing surcharges on consumers who use payment cards. Several other states, including Florida, California and Illinois, have enacted similar laws. Critics of state no-surcharge laws (as well as some courts) contend that, because surcharging and discounting are effectively economically indistinguishable, the only difference between them is the label used to describe them, and thus that banning one of these labels constitutes an impermissible state restriction on commercial speech:

> The Eleventh Circuit… in reviewing Florida's credit-card surcharge ban under the First Amendment [held that]: "[t]autologically speaking, surcharges and discounts are nothing more than two sides of the same coin; a surcharge is simply a 'negative' discount, and a discount is a 'negative' surcharge." The panel thus recognized that the "sole effect" of Florida's surcharge ban was to keep sellers "from uttering the word surcharge, criminalizing speech that [was] neither false nor misleading."[2]

Federal law already bans state laws or private contractual restrictions that would prohibit merchants from offering *discounts* to consumers who pay with cash in lieu of credit cards. Should the Supreme Court also similarly prohibit state law bans on *surcharging* under the Constitution?

In *Expressions Hair Design v. New York*, the Second Circuit, reversing the district court, upheld New York's law, rejecting the merchants' claim that permitting merchants to refer to "cash discounts," but not to refer to "credit surcharges," constitutes an impermissible restraint on commercial speech under the First Amendment. Other challenges in other states have been brought on the same or similar grounds, resulting in a circuit split between the Second and Fifth Circuits

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[1] Expressions Hair Design v. Schneiderman, 808 F.3d 118 (2d Cir. 2015), *cert. granted*, 137 S. Ct. 30 (2016).

[2] Brief of *Amici Curiae* First Amendment Scholars & First Amendment Lawyers Association in Support of Petitioners, Expressions Hair Design v. Schneiderman, No.15-1391, 2016 WL 6994874 (U.S. Nov. 21, 2016) (citations omitted) [hereinafter First Amendment Scholars Merits Amicus].

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on one side, and the Eleventh Circuit on the other.[3] The merchant challengers of these laws argue that, because the laws prohibit them from *posting* a single, cash price (and then charging credit card customers more than the posted price at the register), their First Amendment rights are impermissibly restricted under the laws. The states that have enacted these laws—and the courts that have upheld them—argue that the statutes do not limit speech but actually limit *conduct*: the *action* of imposing a monetary surcharge on a consumer who desires to use a payment card, not the mere *labeling* of the practice as either a cash discount or a surcharge.[4]

Although the merchants' core argument rests on the First Amendment, they invoke behavioral law and economics ("BLE") to support their claim. Specifically, they argue that, from the perspective of consumers, it actually matters whether a particular price adjustment is quoted as a surcharge or a discount—that its *label*, and not its underlying mechanics, affects consumer conduct.[5]

Based on various concepts taken from Behavioral Economics ("BE"),[6] the merchants argue that there is no relevant difference between the conduct involved in surcharging versus discounting; that labeling a particular price adjustment to be a "surcharge" will be more effective at diverting consumers away from network-branded credit cards; and that this will lead to increased use of supposedly less-expensive payment devices such as cash:

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[3] *See, e.g.,* Italian Colors Rest. v. Harris, 99 F. Supp. 3d 1199, 1203 (E.D. Cal. 2015).

[4] *See* Expressions Hair Design, *supra* note 1, at 134–35 ("As applied to single-sticker-price schemes like the ones described in Plaintiffs' submissions, Section 518 regulates conduct, not speech").

[5] The merchants summarize the behavioral economics logic with a quote from Cass Sunstein: "People are averse to losses … [S]imply through inventive terminology, it is possible to manipulate the frame so as to make a change appear to be a loss rather than a gain, or vice versa… [e.g.,] a company that says 'cash discount' rather than 'credit card surcharge.'" Sunstein, *What's Available? Social Influences and Behavioral Economics*, 97 Nw. U. L. Rev. 1295, 1312 (2003).

[6] In this article we distinguish between "Behavioral Economics" ("BE") on the one hand, which refers to the scientific enterprise of identifying certain patterns of individual choice that identify certain ostensibly predictable, systematic biases in consumer decision-making, and Behavioral Law and Economics ("BLE") on the other, which refers to the efforts to apply those purported BE biases in the context of legal reasoning and policymaking in the real world. In short, BE seeks to *describe* and *explain* certain seemingly anomalous human behavior, while BLE seeks to *justify* and *recommend* specific policy interventions based on BE's behavioral explanations. While, as we discuss, BE itself is often extremely indeterminate, its imprecision (and even frequent inherent conflicts) are magnified by BLE scholars who pick and choose from among its hypotheses and claims in order to contrive "scientific" support for their idiosyncratic policy preferences.

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> Because both credit-card surcharges and cash discounts ultimately amount to equivalent differences between the price charged to credit-card customers and the price charged to cash customers…, [a no-surcharging law] burdens protected expression by "draw[ing] the line between prohibited 'surcharges' and permissible 'discounts' based on words and labels, rather than economic realities."[7]
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> In Plaintiffs' view, credit-card surcharges and cash discounts must just be labels because consumers react differently to them: they react more negatively to credit- card surcharges than they react to cash discounts.[8]

The plaintiff merchants, joined by *amici* briefs from some academics, invoke BLE in support of these claims.[9]

Although behavioral law and economics has taken the legal academy by storm in the past decade, this effort to justify the plaintiffs' case on BLE analysis represents one of the highest-profile efforts to date to try to leverage behavioral economics for legal and policy change.[10] As such, this case is particularly important in that it represents the first major opportunity for the Supreme Court to confront BLE, to

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[7] Expressions Hair Design, 808 F.3d at 131 (quoting Expressions Hair Design v. Schneiderman, 975 F. Supp. 2d 430, 444 (S.D.N.Y. 2013) [hereinafter Expressions District Opinion]).

[8] *Id.* at 132.

[9] *See* Brief of Scholars of Behavioral Economics as *Amici Curiae* in Support of Petition for Writ of Certiorari, Expressions Hair Design v. Schneiderman, No 15-1391 (U.S. Jun. 15, 2016) [hereinafter BLE Scholars Cert. Amicus], *available at* https://goo.gl/FRWFI7. While the scholars on whose behalf this brief was filed style themselves as "Scholars of Behavioral Economics," they are not primarily behavioral economists, but rather scholars of behavioral *law* and economics, and all but one of the signatories to the brief are law school professors. The amici include law professors Oren Bar-Gill, Susan Block-Lieb, Edward Janger, Adam Levitin, and Lauren Willis, Professor of Law and Psychology Tess Wilkinson-Ryan, and economist Jonathan Zinman. Although the brief was filed on behalf of the entire group, the underlying arguments were developed by Professor Adam Levitin approximately a decade earlier, and the brief closely follows Levitin's analysis. *See* Adam J. Levitin, *Priceless? The Economic Costs of Credit Card Merchant Restraints*, 55 UCLA L. REV. 1321 (2008); Adam J. Levitin, *The Antitrust Super Bowl: America's Payment System, No-Surcharge Rules, and the Hidden Costs of Credit*, 3 BERKELEY BUS. L. J. 265 (2005).

[10] *Id.* ("*Amici* believe that this case—which concerns the significance of framing effects under the First Amendment—presents perhaps the first opportunity for this Court to consider the insights of behavioral-economic theory in reaching its decision.").

(cont.)

evaluate the scientific validity of BLE arguments, and to determine how those arguments will be applied and interpreted in future cases that come before the Court—and, by implication, lower courts. Thus, we believe that the arguments in this case are worthy of particular scrutiny.

Moreover, because of the nature of the litigation to date, although the plaintiffs have offered these arguments in their case—indeed, they comprise the opening pages in the plaintiffs' petition for *certiorari* to the Supreme Court, permeate the plaintiffs' merits brief in the case,[11] and constitute the focus of several *amicus* briefs in support of the plaintiffs[12]—the states that have defended the law in court have not addressed the BLE arguments that have been raised, but have focused on the narrow, doctrinal aspects of the First Amendment and Due Process issues at stake.[13] Nor have those arguments yet been addressed in *amicus* briefs filed in *defense* of the laws (and in opposition to the plaintiffs' representation of the BLE arguments). As a result, although the plaintiffs and *amicus* supporters have invoked BLE arguments in support of their case, their assertions and representations have not been seriously scrutinized by courts.

Moreover, judges in several of the cases have considered the plaintiffs' BLE arguments, in a largely approving manner.[14] Even where judges have rejected the First Amendment challenges and upheld the laws, in some cases the courts have nevertheless uncritically accepted the accuracy of the BLE claims even if they are ultimately considered to be irrelevant to the core claims of the case or insufficient to strike down the state laws.

In this article, we take no position on the First Amendment questions in the case regarding whether the anti-surcharge laws represent impermissible restrictions on

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[11] *See generally* Brief for Petitioner, Expressions Hair Design v. Schneiderman, No. 15-1391, 2016 WL 6833414 (U.S. Nov. 14, 2016).

[12] *See, e.g.*, Brief of Scholars of Behavioral Economics as *Amici Curiae* in Support of Petitioners, Expressions Hair Design v. Schneiderman, No.15-1391, 2016 WL 6994874 (U.S. Nov. 21, 2016) [hereinafter BE Scholars Merits Amicus]; BLE Scholars Cert. Amicus, *supra* note 9; First Amendment Scholars Merits Amicus, *supra* note 2, Brief of *Amicus Curiae* Professor Adam J. Levitin in Support of Petitioners, Expressions Hair Design v. Schneiderman, No. 15-1391, 2016 WL 6994877 (U.S. Nov. 14, 2016).

[13] The Second Circuit, for example, effectively side-stepped the issue by holding that the statute at issue "does not prohibit sellers from referring to credit-cash price differentials as credit-card surcharges, or from engaging in advocacy related to credit-card surcharges; it simply prohibits imposing credit-card surcharges." Expressions Hair Design, *supra* note 1, at 131.

[14] *See, e.g.*, Italian Colors, *supra* note 3, at 1204; Expressions District Opinion, *supra* note 7, at 436–37.

merchant speech or conduct; there may well be non-BLE, doctrinal bases for treating anti-surcharge laws as impermissible infringements on speech. But we do take issue with the manner in which BLE arguments have been used in the case. And, to the extent that the First Amendment arguments turn on BLE and on the merchants' presentation of the BLE literature, we find them seriously wanting. Because of the significance of BLE to this case, and because this case may set a precedent for the future use of BLE by courts, those arguments demand deeper scrutiny to understand the nature and accuracy of the claims.

The BLE scholars who have weighed in on the case argue that merchants must be permitted to offer card surcharges and not merely cash discounts because, although they result in the "same" ultimate conduct (i.e., differential pricing depending upon the form of payment), surcharging is a more forceful means of persuading consumers to shift to alternate payment schemes:

> In the context of credit card surcharging, behavioral economics has shown that consumers react very differently to discounts and surcharges. A discount is perceived as a "reward" for a cash purchase, generating a mild, positive reaction. A surcharge is perceived as a "penalty" for a credit purchase, garnering a much stronger, negative reaction. In this way, a merchant's ability to incentivize use of a preferred payment method is diminished by the limits no-surcharge laws place on the way the merchants describe the price differential.[15]

For these scholars, "surcharges and cash discounts are just two ways of conveying identical information about the relationship between two prices."[16] That is, they assert, both practices comprise the *same conduct*, but are only described using different words. As a group of First Amendment Scholars who weighed in on behalf of the Petitioners describe it:

> This analysis presumes that a "surcharge" exists only when a seller requires a credit-card user to pay more than a given sticker price (e.g., "$100 plus $2 for credit- card users"). But a surcharge exists in equal measure when a seller requires a credit-card user to pay more than a cash user (e.g., "$102 minus $2 for cash users"). In both instances, the consumer pays more for using a credit card (i.e.,

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[15] BLE Scholars Cert. Amicus, *supra* note 9, at 3.

[16] *Id.* at 2.

(cont.)

> $102)—the only difference is how the seller explains this excess charge to the consumer (i.e., by using the term "surcharge" versus "discount").[17]

But the BLE scholars also assert that, despite describing identical conduct, people respond differently to the different labels, meaning that the different labels *themselves* supposedly have different effects on consumer behavior. Thus, statutes that prohibit one form of communication and not the other amount to impermissible restrictions on speech. As the Second Circuit neatly sums it up: "In Plaintiffs' view, [given their equivalent mathematical content,] credit-card surcharges and cash discounts must just be labels because consumers react differently to them: they react more negatively to credit-card surcharges than they react to cash discounts."[18]

This argument assumes that merely *calling* the behavior surcharging instead of discounting can convey valuable information that will affect consumer behavior, and thus that the case is solely about *speech*. Crucial to the argument, therefore, is that the *labels* are applied to functionally identical behavior—that there is nothing in the way of *conduct* or behavior entailed when a merchant assesses a surcharge or offers a cash discount to shoppers.

Right off the bat, however, there is an obvious problem with this argument. As the example above suggests, a merchant must set a *different* base price for discounting and surcharging if she is going to maintain their mathematical equivalence. Because a posted price affects (and is affected by) market competition, it may not be equally feasible for a merchant to set the posted, base price at both amounts necessary to maintain the mathematical equivalence asserted by stylized examples. At the same time, a surcharge is manifestly *not* the same as a discount: When a consumer is met at the register with a *higher* price than that posted when she selected the store or chose her items (all of a sudden $100 becomes $102) there is an element of deception in the price.[19]

This is, at its core, a form of bait-and-switch advertising. Credit-card surcharges are often employed in precisely this manner, as they allow merchants to entice

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[17] First Amendment Scholars Merits Amicus, *supra* note 2, at 12-13.

[18] Expressions Hair Design, *supra* note 1, at 132.

[19] Obviously, a *lower* price at the register because of a discount would also represent a deviation from the posted price, but for equally obvious reasons there is no *harm* associated with such a deviation, and no one would call it "deceptive."

(cont.)

potential customers by advertising a low regular price, and then "hold up" customers who wish to pay (or who can only pay) via credit card.[20] And because this practice "reduces the extent to which consumers [can] shop around and compare full price offers," it "weakens the competitive pressure between retailers" and often results in "consumers not getting the best deal."[21]

To illustrate, suppose a consumer wants to buy a mattress. Store A advertises a price of $1,000, while Store B advertises a price of $1,030. Because the consumer buys a mattress only once every ten years, she does not readily know that only Store B's advertised price reflects all relevant surcharges, nor does she know that Store A imposes a surcharge at the register, or how much that surcharge is. Accordingly, the consumer decides to shop at Store A. After spending an hour laying down on every mattress in the store, the consumer finally chooses the one she wants to buy. But when she reaches the checkout, the consumer learns that the advertised price of $1,000 does not include a 6% surcharge, which brings the grand total to $1,060. Because the consumer is carrying only $22 in cash (as the typical American consumers does),[22] and because the $30 difference between the two stores' credit-card prices may well be less than the value of the time it would take to find a comparable mattress at Store B, the customer is effectively locked into paying the higher price.[23]

Finally, as the BLE scholars themselves argue, discounting and surcharging *do* have different effects on consumer behavior: While, as we discuss below, all available evidence suggests they are wrong about the *direction* of the relative effects, there is no doubt that they could (and quite possibly do) have different effects. Supporters of the Supreme Court appeal argue that this shows merely that the different *labels* matter (and thus that they should be protected as speech). But it is

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[20] See Hélène Bourguignon, Renato Gomes & Jean Tirole, *Card Surcharges and Cash Discounts: Simple Economics and Regulatory Lessons*, 10(2) COMPETITION POL'Y INT'L 13, 20 (Autumn 2014).

[21] UNITED KINGDOM OFFICE OF FAIR TRADING, PAYMENT SURCHARGES: RESPONSE TO THE WHICH? SUPER-COMPLAINT 30 (July 2012) at 7 [hereinafter OFT PAYMENT SURCHARGES STUDY], *available at* http://webarchive.nationalarchives.gov.uk/20140402142426/http://www.oft.gov.uk/shared_oft/super-complaints/OFT1349resp.pdf.

[22] *See* Claire Greene & Scott Schuh, *Consumers' Holdings and Use of $100 Bills*, FEDERAL RESERVE BANK OF BOSTON RESEARCH DATA REPORTS, No. 14-3 (Nov. 25, 2014).

[23] Advertising, review websites, and the like can, in some cases, inform the consumer of the surcharge, of course, even if she does not have first-hand knowledge. But these devices are imperfect, and the "bait-and-switch" dynamic will play out at the margin as long as search costs are positive. As we discuss below, it is for this reason that merchants tend to impose at-the-register surcharges where search costs tend to be higher (*e.g.*, in the travel industry). *See infra* notes ____ and accompanying text.

far more straightforward to see that a discount is meaningfully different than a surcharge, whatever their nominal mathematical equivalence, and that the difference is not simply a function of how they're labeled but rather how they are devised, implemented, and disclosed by merchants, and how they are understood by consumers.

In this article, we address the BLE arguments and evidence that are advanced in support of the claim that merely *calling* a certain practice a credit surcharge as opposed to a cash discount will affect consumer behavior in a predictable manner and, in particular, that assessing a credit surcharge instead of offering a cash discount will be more effective at leading consumers to pay for retail transactions with cash rather than credit. Examining the accuracy of this claim, we find that both economic theory and the available empirical evidence strongly rebut the BLE arguments that have been advanced. The arguments that have been presented to courts—including the Supreme Court—are at best confused, and at worse disingenuous and misleading, especially regarding their characterization of the limited empirical evidence that is available to date.

More fundamentally, the existing state of the BE literature on which the BLE arguments are based is not sufficiently firm to provide a foundation for entrenching those concepts in policy, much less constitutional law. The Supreme Court (and lower courts) should be especially wary of doing so when, as here, standard economic analysis provides a more persuasive and empirically-grounded justification for treating surcharging and discounting differently, as well as for private or state restrictions on credit card surcharging. Indeed, because the more traditional analysis points toward merchant opportunism (not, as the BLE arguments would have it, consumer protection) as the basis for their advocacy in favor of the ability to surcharge for credit payments, the Supreme Court should be even *more* cautious in adopting BLE theory that may be nothing more than a convenient rationale for merchants seeking to extract wealth from consumers.

Indeed, in some instances the key studies relied upon by the plaintiffs and their supporters actually *rebut* the claims for which the studies are advanced.[24] In particular, available evidence indicates that cash discounting may actually be *more* effective than surcharging at persuading consumers to switch to an alternative form of payment.[25] Studies that the merchants advance in support of their contrary argument either in fact *contradict* their arguments, or simply do not stand for the

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[24] *See, infra,* The Evidence "Supporting" BLE Claims, p.- 33 -, ff.

[25] *Id.*

conclusions for which the merchants offer them: that the "negative" penalty of surcharging is more effective at shaping consumer behavior than is cash discounting. In addition, we have located additional evidence drawn from real-world contexts (rather than surveys based on hypothetical scenarios) not discussed by the merchants or BLE scholars that further confirms our analysis challenging the claim that surcharging is more effective than cash discounting in altering consumer conduct.

It is important to note, however, that critics of no-surcharge rules do assert their own strategic story for the defense of no-surcharge rules offered by payment card networks. In brief, some scholars have suggested that, precisely because surcharging is more effective than discounting at moving consumers away from payment cards, networks and card issuers have worked more vigorously to influence lawmakers to enact laws discouraging surcharging relative to those discouraging discounting. Indeed, it appears to be the case that the existing state no-surcharge rules were proposed and enacted in part due to lobbying by the payment card industry,[26]and pressure for more of these bans continues apace.[27] Assuming this behavior was rational, those lobbyists certainly believed there was something to be gained from such lobbying.[28]

Thus, it very well could be the case that the industry believes that surcharging is more effective at altering consumer behavior than is discounting,[29] and that some federal agencies believe that surcharge bans do not, in fact, protect consumers. But it also doesn't matter: The question at hand is not whether the payment card companies *believe* that in some instances surcharging is more effective at altering consumer behavior, but what the *evidence shows* regarding the effects on consumer

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[26] Expressions District Opinion, *supra* note 7 at 439; Levitin, *The Antitrust Super Bowl: America's Payment System, No-Surcharge Rules, and the Hidden Costs of Credit, supra* note 9, at 276 n.35.

[27] *See Credit or Debit Card Interest, Surcharges, and Fees 2013 Legislation*, NAT'L CONF. OF ST. LEGISLATURES (July 15, 2013), http://www.ncsl.org/research/financial-services-and-commerce/credit-or-debit-card-surcharges-2013-legis.aspx.

[28] Bolstering these claims, it also appears that federal agencies, including the FTC, were actively against extending the federal ban on surcharges, *See* S. REP. NO. 97-23, at 10 (1981) (comments of Sen. Proxmire). And—at least according to the Plaintiffs in the Second Circuit case—the card industry went to the effort of creating an "astroturf" consumer group to oppose merchant surcharging. *See* Corrected Brief for Plaintiffs-Appellees Expressions Hair Design, *et al.*, Expressions District Opinion, *supra* note 7. We hasten to note, however, that the evidence cited in the brief for the "astroturf" claim was not actually accessible as provided.

[29] It bears noting, however, that both surcharging *and* discounting were banned in the original network agreements, so it may just be the case that these companies prefer to handle all contingencies, without necessarily believing any one of them is more likely than another.

welfare. And on this question, our interpretation of the *evidence* indicates that the reality is, in fact, that surcharging is no more effective than discounting at encouraging consumers to use cash (or is even *less* effective at doing so).

If our interpretation is accurate, this reality is also presumably understood by the merchants, who have the best, private evidence regarding the practices and their effects. So why then do merchants nevertheless insist on retaining the right to surcharge, if their claimed objective—moving customers to cheaper forms of payment—is best accomplished by discounting? We consider an alternative hypothesis: that merchants seek the power to surcharge (in addition to their already-guaranteed right to discount) in order to price discriminate against certain consumers, especially those consumers who face limited alternatives to using payment cards to make certain types of purchases, such as airline tickets, hotels, and travel purchases. Indeed, it seems that merchants prefer surcharging to discounting not because consumers are *more* likely to switch to cash in the face of a surcharge but precisely because consumers are *less* likely to switch.

Examining the experience of countries that have permitted surcharging of card payments, including England, Australia, and the Netherlands, it is apparent that merchants do not impose surcharges merely to recover their costs of card acceptance. Instead, the surcharges imposed tend to be at levels far above cost, and tend to be imposed where market conditions best enable merchants to take advantage of consumers for whom paying with credit is preferable, even in the face of excessive fees. In fact, it is precisely because of their fear that merchants would opportunistically take advantage of consumers who need to use payment cards that card networks have insisted on banning surcharging in their service contracts with merchants since the very earliest days of general acceptance credit cards issued by American Express and Bank AmeriCard.[30]

In 2013, however, the networks settled antitrust litigation brought by a class of merchants, accepting a settlement term that resulted in the elimination of their use of contractual bans on surcharging.[31] Nevertheless, the underlying concerns that

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[30] As professor Adam Levitin recounts, the vice-president and general counsel of Carte Blanche testified before Congress that the first no-surcharge/no-discount provision was introduced by Diners Club in the 1950s to address the problem of merchants who advertised cash discounts to Diner's Club users. *See* Levitin, *Priceless? The Economic Costs of Credit Card Merchant Restraints*, *supra* note 9, at 1371.

[31] In re Payment Card Interchange Fee & Merch. Disc. Antitrust Litig., 986 F. Supp. 2d 207, 214 (E.D.N.Y. 2013), *rev'd and vacated*, 827 F.3d 223 (2d Cir. 2016) [hereinafter Interchange Antitrust Litigation].

animated the card networks to include those provisions in their contracts remain. Whether those concerns are properly addressed by state laws that continue to ban surcharging, or by more sensible antitrust policies (and better-drafted settlements) is an issue we do not directly address in this article. Nevertheless, whatever the merits of any particular piece of legislation, our analysis does point to a seemingly legitimate consumer protection issue.

For current purposes, however, our conclusion is simple, but, we believe, crucial: In the realm of consumer credit regulation, at least, judges, legislators, and regulators should remain skeptical about arguments for legal reform based on BE and BLE. Although it is certainly possible that future evidence might support BE hypotheses and the relevance to the evaluation of consumer credit regulations given them by BLE analysis, to date the evidence fails to do so. Indeed, so indeterminate are the conclusions of behavioral economics and the resulting claims made by BLE scholars that the United Kingdom's Office of Fair Trading ("OFT") has published a comprehensive study concluding that permitting credit card surcharging can be harmful to consumers—and pointing to precisely the same biases invoked by American BLE scholars to reach exactly the opposite policy implications.[32]

And, especially as various ideas derived from BLE scholarship continue to seep into the conventional wisdom of the legal academy, it is important to reiterate that the failure of the evidence to support BLE scholars' claims regarding surcharging is not unique. For one financial market and product after another, BLE theorists have constructed models of supposed systematic consumer bias and irrationality, purportedly supporting the writers' particular preferences for legal and regulatory reform. But in case after case, these theories and their claimed implications fail to stand up once they are actually evaluated and tested against available evidence, including with respect to: debit cards,[33] credit card borrowing,[34] credit card fees,[35]

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[32] OFT PAYMENT SURCHARGES STUDY, *supra* note 21.

[33] See Thomas A. Durkin, Gregory Elliehausen, & Todd J. Zywicki, *An Assessment of Behavioral Law and Economics Contentions and What We Know Empirically About Credit Card Use by Consumers*, 22 S. CT. ECON. REV. 1 (2014).

[34] *See* Tom Brown & Lacey Plache, *Paying with Plastic: Maybe Not So Crazy*, 73 U. CHI. L. REV. 63 (2006).

[35] *Id.* at 84.

(cont.)

bankruptcy,[36] household savings behavior,[37] payday loans,[38] consumer use of overdraft protection,[39] and subprime mortgages.[40]

It is virtually impossible to escape the conclusion that, whatever promise BE and BLE may hold, they as yet offer little more than a host of oft-conflicting theories and "just-so stories" insufficient to explain consumer behavior or justify its regulation in any particular fashion.[41] This uniformly underwhelming track record of BLE in attempting to convert supposed anomalies found in economics lab experiments into real-world realities should give courts serious pause before following academia into the faddish regulatory proposals offered by BLE academics.

Surcharges, Discounts, and Payment Card Regulation: Everything Old Is New Again

The use of consumer credit to facilitate retail transactions is almost as old as retailing itself—and so, too, are the problems of strategic behavior by retailers, and the use of various institutional devices (like no-surcharge rules) to combat them.

Beginning in the late 19th Century Sears & Roebuck introduced its famous catalogue, which was aimed at rural communities and expanded the range of goods available to purchase. In order to shop from the Sears & Roebuck catalogue, however, consumers had to have a Sears charge account.[42]

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[36] See Robert K. Rasmussen, *Behavioral Economics, the Economic Analysis of Bankruptcy Law and the Pricing of Credit*, 51 VAND. L. REV. 1679 (1998).

[37] Todd J. Zywicki, *Do Americans Really Save Too Little and Should We Nudge Them to Save More? The Ethics of Nudging Retirement Savings*, __ GEORGETOWN J. OF LAW & PUBLIC POLICY __ (Forthcoming 2016).

[38] Ronald Mann, *Testing the Optimism of Payday Loan Borrowers*, 21 S. CT. ECON. REV. 105 (2014).

[39] *See* Adam Smith & Todd J. Zywicki, *Nudging in an Evolving Marketplace: How Markets Improve Their Own Choice Architecture*, George Mason Law & Economics Research Paper No. 16-21 (Apr. 1, 2016), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2757712.

[40] Todd J. Zywicki, *The Behavioral Law and Economics of Fixed-Rate Mortgages (And Other Just-So Stories)*, 21 S. CT. ECON. REV. 157 (2014) [hereinafter Zywicki, *Just-So Stories*].

[41] *Id.*

[42] *See* Todd J. Zywicki, *The Economics of Credit Cards*, 3 CHAPMAN L. REV. 79 (2000).

(cont.)

As the American consumer economy grew rapidly during the inter-War and post-World War II era, credit and its related delivery technologies underwent similarly rapid development.[43]

Despite the high costs and risk of offering credit services to consumers, department stores did not impose a surcharge on their customers that used credit, nor did they typically provide a discount for cash customers. Instead, department stores typically operated their credit operations at a loss, essentially resulting in cash customers subsidizing credit customers. Moreover, because of strict usury ceilings in some states,[44] retailers would mark up the sticker price of the goods most frequently purchased on credit—appliances, furniture, and other household durable goods—in order to offset losses on their credit operations.[45]

Despite these economic realities, department stores offered credit to their customers as a convenience, to enable efficient household investment in consumer durable goods, and to build customer loyalty, a strategy that increased sales over time.[46] Notably, this subsidization continues today at many stores. For instance, in its "Red Card" program, Target bears both the risk of default and the cost of billing and operations. Thus, by definition, those consumers that use the Red Card are costlier for Target than those who use cash. Nevertheless, Target does not surcharge Red Card customers, nor does it even charge the same price—instead, Target *subsidizes* use of its Red Card by offering 5% back on all purchases.[47] Yet Target offers this subsidy because of the value that the Red Card provides to the store in the form of convenience to consumers, attendant consumer loyalty, and very valuable marketing information that the program generates. Macy's similarly offers special discounts and benefits (such as free shipping for online shoppers) to

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[43] *See* THOMAS A. DURKIN, *ET AL.*, CONSUMER CREDIT AND THE AMERICAN ECONOMY (2014).

[44] Prior to Marquette Nat'l Bank v. First of Omaha Serv. Corp., 439 U.S. 299 (1978), states were free to set usury limits on credit cards based on the location of the borrower. After Marquette, however, the usury limit was determined based on the principal location of the lending institution—a change that led to a competition among states to progressive increase and eventually eliminate usury limits. David A. Moss & Gibbs A. Johnson, *The Rise of Consumer Bankruptcy: Evolution, Revolution, or Both?*, 73 AM. BANKR. L. J. 311 (1999).

[45] *See generally* Todd Zywicki, *The Economics of Credit Card Interchange Fees and the Limits of Regulation*, ICLE White Paper (June 2, 2010), *available at* http://www.laweconcenter.org/images/articles/zywicki_interchange.pdf.

[46] *Id.*

[47] REDcard Homepage, TARGET, *available at* http://www.target.com/c/redcard/-/N-4tfyn (last visited Dec. 7, 2016).

(cont.)

customers who use its store-brand card that are not available to other shoppers, despite the cost and risk to Macy's of running its own store-brand card system.

And, more generally, cross-subsidies between different types of consumers are ubiquitous in American retailing, not just with respect to credit versus cash. Such subsidy differentiation can often include features like free parking, free assistance by sales clerks in a store, free returns, and a host of other unpriced ("free") conveniences that retailers provide that result in a variety of cross-subsidies between consumers.

In 1950,[48] Diner's Club introduced the first general purpose charge cards. Unlike previous charge and credit cards, which were accepted at only one retail chain or gas company, Diner's Club created a network of hotels and restaurants that would accept the card. As a general acceptance card, Diner's Club provided a huge convenience for both consumers as well as the retailers that accepted it: the card's network effects enlarged the pool of potential customers and retailers to each group's mutual benefit.

In addition, accepting Diner's Club relieved a merchant of the cost and risk associated with running its own internal credit system. This enabled smaller and independent restaurants and hotels to more directly compete with large department stores, gasoline companies, and retailers who could otherwise more easily afford to cover the costs and risks of internally run credit systems.

Yet despite the value provided to consumers and merchants from the development of general purpose payment cards, these cards also created a new problem that traditional retail credit did not—when retailers provided their own credit, they captured both the benefit and bore the cost of their operations. Accepting general purpose charge and credit cards provided a benefit to merchants by relieving them from the burden and cost of providing their own store credit (and, perhaps, by increasing sales).[49] Nevertheless, merchants had an incentive to try to appropriate the value of the card network without bearing the cost.

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[48] *The Story Behind the Card*, DINER'S CLUB INTERNATIONAL, *available at* https://www.dinersclubus.com/home/about/dinersclub/story (last visited Dec. 1, 2016).

[49] *See* Ian Lee, Geoffrey A. Manne, Julian Morris & Todd J. Zywicki, *Credit Where It's Due: How payment cards benefit Canadian merchants and consumers, and how regulation can harm them*, Macdonald-Laurier Institute Paper (Oct. 2013), *available at* http://www.macdonaldlaurier.ca/files/pdf/MLIPaymentCardRegulation10-13Draft5.pdf.

Consider a restaurant in New York City that catered to traveling businessmen, for example. The restaurant could advertise itself as being part of the Diner's Club network, thereby associating itself with the Diner's Club brand and gaining access to an upscale, high-value market of potential customers. Yet, at the same time, many of these customers would not be repeat customers (which is precisely one reason why the restaurant would market itself as part of the Diner's Club network: to signal potential patrons otherwise unfamiliar with the establishment). As a result, the restaurant would have an incentive to lure customers in by branding itself as part of the Diner's Club network, but also to later impose a surcharge on their bills in order to recoup the 7 percent merchant discount that it had to pay to Diner's Club (and, where possible, a little extra, as well).[50]

This example could be replicated in many other markets, notably those related with travel and tourist services, that cater to those who have a particularly high demand for using credit cards and for which merchants may expect a relatively low level of repeat patronage.

In other words, some merchants will naturally have an incentive to engage in strategic behavior—attempting to capture for themselves the full value of the card network, only to turn around and price discriminate by imposing a surcharge to try to recoup the cost that they pay for that service. Whatever the reduction in the network's value caused by this conduct, each merchant would bear only a fraction of that cost, but enjoy the full benefit of the surcharge. So, each establishment in the network would have the individual incentive to cheat, to the collective harm of everyone.

By constraining merchants from opportunistically imposing surcharges on consumers at the point of sale, the network guarantees a "frictionless and consistent point-of-sale experience when using their… cards," as the District Court for the Eastern District of New York recently wrote in a related context.[51] Thus, restraining opportunistic surcharging benefits all of the members of the network by guaranteeing the ubiquitous and non-discriminatory acceptance of cards—consumers, issuers, and, most relevant, merchants too, who benefit indirectly from the security that consumers receive from knowing that they can use their cards.

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[50] The original Diner's Club charged an annual fee of $5 to users (equivalent to $49 today) and a fee of 7 to 10 percent of the charge to the business that accepted the card. *See* Alan Flippen, *The Dawn of Diners Club, and the Credit Card*, N.Y. TIMES (Oct. 23, 2014), *available at* http://www.nytimes.com/2014/10/24/upshot/the-dawn-of-diners-club-and-the-credit-card.html.

[51] United States v. Am. Express Co., 88 F. Supp. 3d 143, 225 (E.D.N.Y. 2015).

Which explains, of course, why merchants would agree to a network-wide no-surcharge rule: to constrain *other* merchants' behavior. The no-surcharge rule, therefore, serves to address the prisoner's dilemma caused by the incentive that individual merchants have to participate in the network on the front end to gain the benefits only to try to opportunistically appropriate economic rents afterwards by imposing surcharges on particular users, which would reduce the overall benefit to all users.[52]

Notably, this also explains why merchants would want to surcharge third-party, general purpose cards (such as Diner's Club in the past or Visa, MasterCard, American Express, or Discover today) yet would *not* impose a surcharge on their own proprietary card operations, for which they bear both the full cost and benefit.[53] The opportunity to surcharge third-party cards enables merchants to gain the benefits of being part of the card network without having to bear the full costs.

More significant than merchants' concerns, however, were the commercial demands of the card issuing banks, who would bear the brunt of the cost through either lower direct fees charged to consumers or lower merchant acceptance of their cards. In order to restrain the incentives for retailer opportunism, card issuers view as an essential component of merchant agreements an ability to restrain merchants from passing on the costs of participation in a payment card network to customers, and from early on in the history of general acceptance credit cards, merchant agreements included provisions prohibiting surcharges and other efforts to pass on the costs of membership to consumers, issuers, or other third parties.[54] In this sense, the card networks were essentially requiring that those retailers that

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[52] In this sense, the incentives of individual merchants resemble the anti-commons problems identified in the often-studied example of the Rhine River during the Middle Ages. When the Holy Roman Empire controlled the entire river, it had the incentive to set the tax at a rate that maximized the value of the river. When the Holy Roman Empire fell, however, the river was controlled by a succession of local German barons along its length. The barons instead had the incentive to maximize their own individual revenue and so each baron asserted a high tax. The overall effect was a disastrous drop in the value of the river as a trading enterprise and a collapse in traffic along the river. *See* MICHAEL HELLER, THE GRIDLOCK ECONOMY: HOW TOO MUCH OWNERSHIP WRECKS MARKETS, STOPS INNOVATION, AND COSTS LIVES (2008); *see also* James Buchanan & Young Yoon, *Symmetric Tragedies: Commons and Anticommons*, 43 J. L. & ECON. 1 (2000).

[53] Notably, merchants consistently demand the right to surcharge *selectively*, presumably so that they can continue to subsidize some preferred payment mechanisms (such as store-brand cards) even if those payment devices are more expensive than alternatives (such as cash).

[54] Expressions Hair Design, *supra* note 1, at 123.

(cont.)

accepted their cards would have to treat their cards at least no worse than their own in-house credit operations.

And far from embodying a one-sided effort by issuers to take advantage of merchants, these so-called "merchant restraints" were consumer protection devices designed to limit opportunistic behavior by those merchants who wished to charge consumers a higher price every time they desired to use the card—thereby adding to the consumer's own cost of participation, which often included annual membership fees. And because many merchants would have realized that there was a net benefit in the network restraining fellow merchants, such provisions would have been (and were) acceded to.

It is thus notable, but not surprising that merchant restraints on potentially opportunistic behavior have been part of credit card contracts since almost their very beginning in the 1950s.[55] Notably, these provisions were spearheaded by niche card providers (T&E cards), and during a period well before ubiquitous ownership and acceptance of general acceptance payment cards and well before it could be reasonably argued that payment card networks had any sort of market power.

The original network agreements contained contractual restraints on both card surcharging as well as cash discounting. In 1974, however, Consumers Union sued American Express and Bank AmeriCard, claiming that their no-surcharge and no-discount rules violated antitrust law.[56] American Express settled the suit two months later by agreeing to rescind its no-discount rule in order to allow merchants to offer cash discounts, but continuing to bar card surcharges. According to Professor Levitin, Consumers Union reached similar agreements with the other card networks at that time.[57]

Since that time, public policy has followed an approach to discounting and surcharging that has consistently treated the one—discounting by merchants—as permissible (if not desirable), and the other—surcharging by merchants—as suspect, at best. Thus, later in 1974, Congress amended the Truth in Lending Act to *require* that merchants be permitted to offer cash discounts (of up to 5 percent), but did not address surcharges.[58] In 1976, Congress passed additional federal

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[55] Levitin, *Priceless? The Economic Costs of Credit Card Merchant Restraints*, *supra* note 9, at 1371.

[56] *Id.* at 1372.

[57] *Id.* at 1380.

[58] *Id.* at 1379.

(cont.)

legislation that did prohibit surcharging, although the law provided that it would automatically sunset in three years.[59] Nevertheless, in 1978, Congress renewed the surcharge ban for an additional three years, but then let it lapse in 1981.[60] That same year, however, Congress passed the Cash Discount Act, which eliminated the five percent cap on allowable cash discounts and extended the anti-surcharge rule for yet another three years.[61] At the time, Congress justified the continued ban on surcharging as an appropriate means of consumer protection aimed against the confusion and deception arising from merchants' frequent use of "bait-and-switch" tactics: essentially, posting one price on the shelf and then surprising customers with a higher price at the checkout register. The Senate Committee Report in support of the Cash Discount Act noted:

> [P]ermitting unlimited cash discounts and prohibiting surcharges allows the competitive free market to operate. Merchants can utilize two-tier pricing systems and thereby price cash purchases lower than credit purchases, if they choose to do so.
>
> But they cannot implement two-tier pricing systems which deceive or mislead the consumer. By permitting only cash discounts, the Committee intends to assure that consumers will be seeing at least the highest possible price they will have to pay when they see a tagged or posted price. In other words, consumers cannot be lured into an establishment on the basis of "low, rock-bottom price" only to find at the cash register that the price will be higher if a credit card is used.[62]

Despite these expressed consumer protection concerns, however, Congress finally allowed the surcharge ban to lapse in 1984, and it has not been renewed by the federal government since.[63]

But the disparate policy treatment of surcharging and discounting still persists. Since 1984, federal law has continued to prohibit state and private restrictions on cash discounts but *not* to limit the power of states to ban or limit surcharging, and

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[59] *Id.* at 1380.

[60] *Id.*

[61] *Id.*

[62] S. REP. 97-23, at 3-4 (1981).

[63] *See* Levitin, *Priceless? The Economic Costs of Credit Card Merchant Restraints*, *supra* note 9, at 1381.

(cont.)

not to impose any limits on private, contractual restrictions on surcharging.[64] Thus, in the wake of the lapse of the federal ban on surcharging, approximately a dozen states enacted state statutory bans on the practice, including many of the country's most populous states, such as New York, California, Florida, Massachusetts, and Texas.[65] As long as the private, contractual restrictions remained in place these state laws were largely symbolic, and, in practice, redundant of the terms of the agreements between the card networks and merchants.

But the situation changed in 2013 when Visa and MasterCard entered into an antitrust class action settlement in a case brought by merchants challenging, among other things, the contractual prohibition on surcharging.[66] As a result of the settlement, merchants would be permitted to surcharge, although subject to limits.[67] In 2016, however, a federal district court rejected the class action settlement, leaving the current status of the litigation, and thus the network contractual restrictions, in a state of uncertainty.[68]

Significant for purposes of this article, as the antitrust settlements eliminated contractual limits on surcharging, the dormant state law prohibitions on surcharging have become relevant for the first time in decades. As a result, merchant plaintiffs brought suit in several courts around the country challenging the state laws in Florida, New York, Texas, and California.

The primary theory of these cases is a claim under the First Amendment that it constitutes an impermissible restraint on commercial speech for states to permit merchants to refer to "cash discounts" but not to refer to "credit surcharges."[69] In

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[64] *Id.*

[65] *Id* at 1381 n. 215 (listing states that ban or limit surcharges). In many states these bans provide minor exceptions, such as allowing government agencies or public utilities to impose surcharges. The legislative history to these proposals suggests that these laws were lobbied for by the credit card industry and lobbied against by merchants with both parties insisting that they were the "true" voice of the consumers, just as the current litigation by the merchants is purportedly justified as benefiting consumers. That consumers themselves did not participate on either side of the debate, or on either side of the current litigation, is hardly surprising in light of standard public choice theory, which predicts that result by consumers.

[66] Interchange Antitrust Litigation, *supra* note 31.

[67] *Id.* at 217.

[68] In re Payment Card Interchange Fee & Merch. Disc. Antitrust Litig., 827 F.3d 223, 231 (2d Cir. 2016).

[69] *See* Expressions Hair Design, *supra* note 1, at 128-30.

(cont.)

response, the states, and the courts that have upheld the laws, argue that the laws do not limit *speech* but actually limit *conduct*—the *action* of imposing a monetary surcharge on a consumer who desires to use a payment card.[70] In this view, the mere label distinguishing between a cash discount and a surcharge is incidental: It is the action of increasing a posted (cash) price at the point of sale (when consumers use cards) that is forbidden.[71]

Interesting as they may be, the First Amendment issues *per se* are not the focus of this paper—although to the extent that the First Amendment arguments rest on the BLE claims that *are* this paper's focus, they are implicated here.

In the next section, we examine the underlying BLE claims that have been advanced in the cases, and the extent to which they have been accepted—largely uncritically—by the courts. We then turn to an examination of the validity of those arguments.

Discounting v. Surcharging: The Path to the Supreme Court

In 2016 the Supreme Court granted *certiorari* in *Expressions Hair Design v. Schneiderman.* The case's First Amendment claims rest in part on concepts and conclusions drawn from BLE. This section reviews the arguments made in *Expressions Hair Design*, as well as other BLE arguments and evidence regarding surcharging and discounting of card payments.

BLE Arguments for Why Merchants Should Be Allowed to Offer Surcharges

In both the lower courts and the Supreme Court, the plaintiffs in surcharge-challenge cases have relied in important respects on BLE arguments. At the core of these arguments is the theoretical truism that a discount for non-card transactions can be mathematically equivalent to a surcharge on card transactions. Thus, a simplistic glance at the practice of surcharging would seem to suggest that a merchant (or consumer) should be indifferent between whether a certain price is labeled as a basic price with an *ex post* "surcharge" attached, or as a different (presumably higher) price with an *ex post* "discount" applied.

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[70] *Id.* at 131.

[71] *Id.*

But, according to the BLE argument in favor of surcharging, people respond differently to discounts and surcharges because of the way they are framed. The basic argument is summarized in the BLE Scholars Cert. Amicus:

> Under traditional economic theory, the market impact of a "cash discount" should be the same as the impact of a "surcharge." Credit card customers pay more, and cash customers pay less, regardless of the label attached. We would thus expect the promise of a cash discount to induce consumers to forego paying with their credit cards to the same extent penalizing them with a surcharge would do so. After all, surcharges and cash discounts are just two ways of conveying identical information about the relationship between two prices.
>
> But pioneering work in the field of behavioral economics teaches that people do not make decisions based strictly on rational calculations. Instead, their decisions can be highly influenced by the manner in which information is presented: a perceived reward garners a minor, positive reaction, while a perceived penalty produces a strong, negative reaction. In this way, framing is a material part of any communication.
>
> In the context of credit card surcharging, behavioral economics has shown that consumers react very differently to discounts and surcharges. A discount is perceived as a "reward" for a cash purchase, generating a mild, positive reaction. A surcharge is perceived as a "penalty" for a credit purchase, garnering a much stronger, negative reaction. In this way, a merchant's ability to incentivize use of a preferred payment method is diminished by the limits no-surcharge laws place on the way the merchants describe the price differential.[72]

The BLE scholars' argument rests on the BE theory of the "framing effect," which "reflects the fact that people will reach different decisions depending on the way

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[72] BLE Scholars Cert. Amicus, *supra* note 9, at 2-3. As noted above, the brief does not actually present *BE* analysis on behalf of BE scholars, but actually presents a *BLE* analysis first propounded by legal scholar, Adam Levitin, on behalf of a group of BLE scholars. *See supra* note 9.

(cont.)

information is presented, despite the fact that the information presented is not substantively altered by its presentation."[73]

Additionally, the BLE brief argues that consumers suffer from a "loss-aversion bias," which leads them to respond more strongly to transactions framed as "losses" as opposed to those framed as "gains."[74] As a result, so the argument goes, consumers will respond more dramatically to a surcharge on credit cards—which is "framed" for consumers as an extra charge incurred during checkout—whereas a discount garners a less intense response because it is perceived as a gain. The brief quotes psychologist Daniel Kahneman for the proposition that "*people will more readily forgo a discount than pay a surcharge*. The two may be economically equivalent, but they are not emotionally equivalent."[75]

Kahneman's comment, however, is entirely conclusory as it applies to the specific issue of credit card surcharging and he cites no empirical support for his claim. Instead, he relies on a thirty-six year old economics journal article by Richard Thaler[76]—who likewise provided no empirical support for his claim, but merely speculated that the reason why credit card issuers opposed surcharges more staunchly than cash discounts was for the supposed reason that consumers would react more adversely to out-of-pocket costs. The entirety of Thaler's argument and support for the proposition is as follows:

> Other kinds of evidence in support of the endowment effect hypothesis are less direct but perhaps more convincing. I refer to instances in which businesses have used the endowment effect to further their interests.
>
> Credit cards provide a particularly clear example. Until recently, credit card companies banned their affiliated stores from charging higher prices to credit card users. A bill to outlaw such agreements was presented to Congress. When it appeared likely that some kind of bill would pass, the credit card lobby turned its attention to form rather than substance. Specifically, it preferred that any difference between cash and credit card customers take the form of a cash

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[73] *Id.* at 6.

[74] *Id.* at 11.

[75] DANIEL KAHNEMAN, THINKING, FAST AND SLOW 364 (2011).

[76] Richard Thaler, *Toward a Positive Theory of Consumer Choice*, 1 J. ECON. BEHAV. & ORG. 39 (1980).

(cont.)

> discount rather than a credit card surcharge. This preference makes sense if consumers would view the cash discount as an opportunity cost of using the credit card but the surcharge as an out-of-pocket cost.[77]

Kahneman and Thaler's evidence-free analysis is unfortunately characteristic of a good deal of BLE—a scholarly methodology that one of us has elsewhere characterized as a "just-so stories" approach to academic research.[78] Instead of following the standard methodological technique of constructing a well-specified hypothesis and then gathering data to test it, the just-so stories approach to behavioral law and economics instead begins with an endpoint it seeks to understand—for example, why credit card issuers were more opposed to surcharges than discounts—and cherry-picks from a list of behavioral biases, a few of which supposedly "explain" the observed behavior. And researchers have identified well in excess of 100 different cognitive biases that supposedly apply in a variety of contexts, many of which contradict one another, and all of which provide material to selectively prove or disprove virtually any proposition.[79]

For example, it is possible to use behavioral economics to "explain" why consumers irrationally select either fixed-rate or adjustable-rate home mortgages, or why they irrationally take mortgages either with or without prepayment

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[77] *Id.* at 45. Thaler does cite to congressional testimony from a Federal Reserve Board member who asserts that "critics argued that a surcharge carries the connotation of a penalty on credit card users while a discount is viewed as a bonus to cash customers. They contended that this difference in psychological impact makes it more likely that surcharge systems will discourage customers from using credit cards." *Id*. at note 6.

[78] *See* Zywicki, *Just-So Stories*, *supra* note 40. It should be emphasized here that the criticisms that follow are primarily directed toward the project of behavioral *law* and economics, i.e., the effort to apply behavioral economics concepts to particular policy questions, not the underlying study of behavioral economics. Although many problems have been identified with that literature as well, including the problem of just-so storytelling, addressing those debates is beyond the scope of this article. We take as given the existence of the supposed biases that have been identified and focus instead on the effort to apply them to real-world contexts. Behavioral economics is at least interesting, whether its claims are descriptively accurate or not. But as another of us has elsewhere noted, "interesting doesn't necessarily mean policy relevant." *See* Geoffrey A. Manne, *Geoffrey Manne on Interesting doesn't necessarily mean policy relevant*, TRUTH ON THE MARKET (Dec. 6, 2010), *available at* https://truthonthemarket.com/2010/12/06/geoffrey-manne-on-interesting-doesnt-necessarily-mean-policy-relevant/.

[79] *See, e.g.*, *List of cognitive biases*, WIKIPEDIA, https://en.wikipedia.org/wiki/List_of_cognitive_biases (last visited, Dec. 7, 2016).

(cont.)

penalties.[80] Indeed, even when confronted with evidence that rebuts their initial hypothesis, some BLE theorists will simply retroactively redefine their original hypothesis.[81] Moreover, as noted above, every BLE prediction to date, when applied to consumer finance, has been rejected when tested empirically.[82]

Unlike Thaler and Kahneman, however, who simply speculate in an off-hand fashion about surcharging, the brief of the behavioral economists supporting *certiorari* in *Expressions Hair Design* offers *some* empirical evidence in support of its claim. Thus the brief cites to the results of a Dutch survey—where consumers expressed a "very negative reaction to surcharges (74 percent of respondents deemed them as "bad" or "very bad"), but not an especially positive reaction to cash discounts (only 22 percent viewed them as "good" or "very good")"[83]—in support of the "framing effect" and the claim that surcharging is more effective at altering consumer behavior than is cash discounting.[84] The brief also refers to an internal study performed by furniture retailer IKEA which suggested that surcharging credit cards results in their decreased usage.[85] And the BE Scholars Merits Amicus adds a description of an additional survey, conducted for purposes of the brief, on consumer behavior in response to surcharging/discounting.[86]

As we discuss below, however, not only is this scant evidence, on many critical points the studies do not support the argument as framed, and, in fact—when fully and fairly analyzed—actually *reject* the argument. We also offer additional evidence below that further undermines the BLE arguments in the brief.

Despite the weak and speculative nature of the analysis and evidence provided, however, several federal circuit and district courts have tacitly accepted these

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[80] *See* Zywicki, *Just-So Stories*, *supra* note 40.

[81] *See* Durkin, *et al.*, *supra* note 33.

[82] *See supra* notes 32-40, and accompanying text.

[83] BLE Scholars Cert. Amicus, *supra* note 9, at 12 (citing E. Vis & J. Toth, *The Abolition of the No-Discrimination Rule,* REPORT FOR EUROPEAN COMMISSION DIRECTORATE GENERAL COMPETITION 12 (2000), *available at* http://www.creditslips.org/files/netherlands-no-discrimination-rule-study.pdf [hereinafter Vis & Toth]).

[84] *See* Levitin, *supra* note 55, at 1352.

[85] *Id.* (citing Scott Schuh, *et al.*, *An Economic Analysis of the 2010 Proposed Settlement Between the Department of Justice and Credit Card Networks*, Public Policy Discussion Papers, Federal Reserve Bank of Boston, No. 11-4, 26-27, *available at* http://www.bostonfed.org/economic/ppdp/2011/ppdp1104.pdf).

[86] *See* BE Scholars Merits Amicus, *supra* note 12.

arguments—and now the plaintiffs and scholars are seeking to have the United States Supreme Court do the same.

In the following section, we provide a brief survey of how lower courts have treated the BLE arguments in the challenges to state anti-surcharge laws in New York, Texas, California, and Florida—an exercise that sheds further light on the nature of the arguments and their place in the policy arguments for which they are offered.

Behavioral Economics and Surcharging in the Lower Courts

The BLE arguments, relying upon the interest revealed by the judiciary in lower court opinions, form an important part of the plaintiffs' arguments before the Supreme Court. As the BLE Cert. Amicus notes,

> *Amici* believe that this case—which concerns the significance of the framing effect under the First Amendment—presents the first petition for certiorari based squarely on behavioral economic theory.[87]

Although several lower courts ignored the BLE arguments in their rulings, BLE arguments figure prominently in several of the opinions, even including the Second Circuit's ruling, which uncritically cited the arguments even though it eventually upheld the New York statute.[88]

But before arriving at the Second Circuit, the BLE arguments were cited in support of Judge Rakoff's decision to enjoin New York's surcharge law in the Southern District of New York. He wrote, "[a] number of studies have indicated… that consumers perceive credit-card surcharges negatively as a kind of loss or penalty, while cash discounts are perceived positively as a kind of gain or bonus."[89] He added that "[p]laintiffs... want to impose credit card surcharges, rather than give cash discounts, and to so inform their customers, precisely because consumers are more likely then to notice the fees, dislike them, and switch to cash in order to avoid them."[90]

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[87] BLE Scholars Cert. Amicus, *supra* note 9, at 1.

[88] Expressions Hair Design, *supra* note 1, at 122-23, 150.

[89] Expressions District Opinion, *supra* note 7, at 436.

[90] *Id.* at 437.

(cont.)

Judge Rakoff also claimed that the inability to surcharge credit cards results in a regressive wealth transfer as surcharge bans "in effect force cash users (who are said to be disproportionately poor and minority persons), to subsidize the retail purchases of credit card users."[91] We have discussed that claim elsewhere in detail and will not revisit that discussion in detail here,[92] although, as we discuss below, surcharging *itself* effects a wealth transfer that is ignored by opponents of the state law bans.[93]

On appeal, the Second Circuit reversed the Southern District of New York on the grounds that the New York law prohibited only certain *conduct* (imposition of a surcharge), and that the law was not a limitation on commercial *speech*.[94] Nevertheless, the Second Circuit approvingly cited behavioral economics studies that supposedly demonstrated that surcharging is more effective than cash discounts at changing consumer payment choices:[95]

"One difference between credit-card surcharges and cash discounts involves consumers' reactions to them. A psychological phenomenon known as 'loss aversion' means that 'changes that make things worse (losses) loom larger than improvements or gains' of an equivalent amount,"[96] according to the Second Circuit. "For this reason, credit-card surcharges are more effective than cash discounts at discourage credit-card use among consumers, which has naturally led credit-card companies to oppose them."[97] But as the court noted (still citing the BE literature):

> In fact, consumers react negatively to credit-card surcharges not because surcharges "communicate" any particular "message," but because consumers dislike being charged extra. See Kahneman et al., [] ("[C]hanges that make things worse (losses) loom larger than

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[91] *Id*.

[92] For an analysis, *see* Lee, *et al.*, *supra* note 49, at 26-33 (discussing claim of regressive wealth transfer from low-income to high-income consumers as a result of payment card usage).

[93] *See infra* notes 150, 208-210, and accompanying text.

[94] Expressions Hair Design, *supra* note 1, at 125.

[95] *Id.* at 122.

[96] *Id.* (citing Daniel Kahneman, *et al.*, *Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias*, 5 J. ECON. PERSPECTIVES 193, 199 (1991)).

[97] *Id.* (citing Richard Thaler, *Toward a Positive Theory of Consumer Choice*, 1 J. ECON. BEHAV. & ORG. 39, 45 (1980)).

(cont.)

> improvements or gains."). If a consumer thinks, based on a seller's sticker price, that she will be paying $100 for the seller's goods or services, then she will be annoyed if it turns out that she actually has to pay $103 simply because she has chosen to use a credit card; by contrast, if the sticker price is $103, she will be less annoyed by having to pay $103, even if cash customers only have to pay $100. Nothing about the consumer's reaction in either situation turns on any words uttered by the seller. And although the difference in the consumer's reaction to the two pricing schemes may be puzzling purely as an economic matter, we are aware of no authority suggesting that the First Amendment prevents states from protecting consumers against irrational psychological annoyances.[98]

On the other hand, the court also acknowledged that anti-surcharge laws could protect consumers from abusive merchant surcharging practices:

> According to proponents of prohibitions on credit-card surcharges, experience also suggests that such surcharges will tend to exceed the amount necessary for the seller to recoup its swipe fees, meaning that sellers will effectively be able to extract windfall profits from credit-card users. By contrast, cash discounts are unlikely to lead to the same problem, because merchants will not set the amount of the discount higher than the marginal cost of credit.[99]

Other courts have followed a similar pattern. The Eastern District of California also referred to BLE arguments in support of its opinion striking down the California surcharge law.[100] In reaching its holding, the court observed that

> Retailers would like to emphasize that the higher price is a surcharge because behavioral economics research has shown that customers are "loss averse" and a potential economic penalty will motivate them to change their behavior more than a potential economic benefit.… It follows, Plaintiffs reason, that the most effective way to encourage customers to switch from credit cards to

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[98] *Id.* at 133.

[99] *Id.* at 123 (citations omitted).

[100] Italian Colors v. Harris, *supra* note 3. This case was appealed to the Ninth Circuit but was stayed pending resolution of the Supreme Court case in *Expressions Hair Design v. Schneiderman*.

(cont.)

> cash payments is to emphasize an economic penalty associated with the use of credit cards.[101]

The court then contended that this dynamic means that the inability to surcharge credit card payments results in a regressive wealth transfer from low-income cash users to higher-income card payers.[102]

In support of the BLE-based arguments, these courts rely on only a small handful of BLE sources, none of them offering empirical support for the claims. Richard Thaler's article, *Toward a Positive Theory of Consumer Choice*, is the most consistently cited.[103] As noted above, however, Thaler's article provides no evidence for his claim, merely supposition and assertion. Two of the cases[104] cite a subsequent literature review article co-authored by Daniel Kahneman, Jack Knetsch, and Thaler: Anomalies: *The Endowment Effect, Loss Aversion, and Status Quo Bias*.[105] Yet that article provides no new evidence or analysis on point, and merely cites Thaler's earlier article without elaboration, asserting inaccurately that Thaler's earlier article "*explains* why firms that charge cash customers one price and credit card customers a higher price always refer to the cash price as a discount rather than the credit card price as a surcharge."[106] Thaler's article, of course, "explains" nothing but merely provides one supposition for the observation without any consideration or refutation of alternative hypotheses as to why consumers and card issuers might be more hostile toward credit card surcharges than cash discounts.

Finally, the opinion for the Southern District of New York provides an additional citation to a 1990 article by Professor Edmund Kitch.[107] Professor Kitch's article

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[101] *Id.* at 1204 (E.D. Cal. 2015) (citations omitted).

[102] *Id.* at 1205. The court also noted that the ability to impose surcharges may also lead to greater competition over interchange fees, which could put downward pressure on interchange fees over time. Although this may be true, it is not necessarily relevant to the underlying question of whether consumers will actually benefit overall from the imposition of surcharges—and is neither in the ambit of a behavioral economics, nor properly before the court, as economic policy is a matter for legislatures to determine.

[103] *See, e.g.,* Expressions Hair Design, *supra* note 1, at 122.

[104] *See id.*; Italian Colors v. Harris, *supra* note 3, at 1204.

[105] Daniel Kahneman, Jack L. Knetsch & Richard H. Thaler, *Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias*, 5 J. ECON. PERSPECTIVES 193 (1991).

[106] *Id.* at 204 (emphasis added).

[107] Edmund W. Kitch, *The Framing Hypothesis: Is It Supported by Credit Card Issuer Opposition to a Surcharge on a Cash Price?*, 6 J. L. ECON. & ORG. 217 (1990).

(cont.)

also adds no new support for the claim, but merely refers to Thaler's "casual attempt to explain this puzzle" of credit card companies' preference for cash discounts instead of surcharges.[108]

Overall, the lower court decisions that discuss and rely on BLE arguments do not add any further evidence to support those claims. What the cases that have struck down state surcharge bans consistently do, however, is to accept the BLE-derived assertion that the only relevant distinction between a surcharge and a discount is a rhetorical one, and that the preference for surcharging stems from an effect wholly attributable to the psychological effect of the label, and not the underlying conduct.

Analysis of the Behavioral Law & Economics Claims on Discounting and Surcharges

Accepting for a moment the characterization of the choice between surcharging and discount as solely a matter of rhetoric, rather than substance, the BLE argument in support of permitting merchants to surcharge rests fundamentally on the claim that a surcharge label is *more effective* than is a discount label in altering consumer behavior.

Moreover, the argument asserts as a corollary that, because surcharges supposedly steer more consumers away from credit card use to alternative payment mechanisms (such as cash or store-branded credit cards), credit card networks and issuers are more strongly averse to allowing surcharges than discounts. Thus BLE scholars and the courts that have accepted their claims also aver that the traditional state interest in prohibiting surcharging—to protect consumers from misleading pricing practices or from being opportunistically held up *ex post* by being charged a higher price at the register than the posted price—is insincere.

Upon closer examination, however, it must be concluded that the BLE argument that surcharging is more effective at changing consumer behavior than is cash discounting is fundamentally unsupported by available evidence. This suggests that the insistence by some merchants on being permitted to surcharge credit cards must be explained by some other dynamic—which we discuss below. That discussion also thus challenges the corollary assertion that the proffered consumer protection interest in surcharge bans is baseless.

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[108] *Id.* at 218.

The Evidence "Supporting" BLE Claims

Consumers Dislike Surcharging More than They Like Discounting: The Dutch Study

The assertion that surcharging is "more effective" than cash discounting rests on scant empirical evidence. The first of these is a survey of Dutch consumers, in which, it is claimed, consumers had a stronger negative reaction to surcharging than they had a positive reaction to cash discounting. In the study, 74% of subjects expressed a negative view when "merchants are allowed to ask for a fee when consumers want to pay with their payment card" (i.e., surcharging), whereas only 21% expressed a positive opinion about "giving a discount when paying with some other means."[109]

Yet simply because some respondents express an opinion that they dislike surcharging does not necessarily mean that surcharging will be more effective at changing consumer behavior. It hardly seems surprising that consumers would find it objectionable for retailers to post one price on the shelf and then surprise the consumer with a higher price at the register. In other words, the expression of dislike for surcharging plausibly reflects a dislike for sharp business practices designed to conceal the true full price of the goods from consumers, rather than a dislike of surcharging per se. As the Second Circuit noted in *Expressions Hair Design*: "If a consumer thinks, based on a seller's sticker price, that she will be paying $100 for the seller's goods or services, then she will be annoyed if it turns out that she actually has to pay $103 simply because she has chosen to use a credit card."[110] Nor does the mere fact that a consumer is "annoyed" by being forced to pay a higher price for using a credit card inherently demonstrate that the reason for the annoyance is some supposed consumer bias as opposed to, say, an expression of distaste for sharp dealing and bait-and-switch sales tactics. And, importantly, without more the fact that a consumer happens to be "annoyed" by a particular merchant practice says nothing about whether consumers will nevertheless accept the additional charge in order to pay with credit anyway, or switch to cash in order to avoid it.

Moreover, merely asking consumers whether they have a negative opinion of surcharging fails to distinguish between answers based on the *theory* of surcharging versus consumers' actual experience with it in *practice*. But this distinction is crucial

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[109] Vis & Toth, *supra* note 83 at 11.

[110] Expressions Hair Design, *supra* note 1, at 133.

to understanding the nature of consumers' conduct—as well as the plausibility of the state's interest in restricting the use of surcharging.

As discussed in detail below, in virtually every country where surcharging has been authorized by law, merchants have routinely been criticized for excessive surcharging (imposing fees extremely in excess of any reasonable estimate of actual cost) and for inadequate disclosure of surcharging practices.[111] Given the documented propensity of merchants in many industries around the world to engage in these behaviors, the adverse reaction to surcharging might well reflect consumers' adverse experience with abusive surcharging *practices*, not a hypothetical aversion to the concept of surcharging *per se*.[112]

And there is a further reason that consumers' reactions to the questions posed in the Dutch study may not reflect the psychological dynamic suggested by BLE: Most cardholders in Holland pay an annual fee for their cards (usually about EUR 34)[113] thus many cardholders might justifiably feel like they have already paid for their share of the cost of operating the credit card network, that doing so should give them full access to the network, and that the merchant is simply acting opportunistically to impose still more costs of operating the payments network on the consumer, or to appropriate some of the cardholders expected value from participating in the network.

Most fundamentally, however, and as discussed below, whether consumers express approval or disapproval of credit card surcharging in the abstract is

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[111] *See* discussion *infra* at notes 168-173, 179-182, 190-195, and accompanying text.

[112] The survey of Dutch consumers did not ask survey respondents whether they thought that the surcharges that they had been offered were adequately disclosed and whether they thought that they were proportional to the underlying cost. On the other hand, other researchers have in fact found that Dutch merchants routinely surcharge at rates that substantially exceed the actual cost differential between cash and credit payments. These findings lend support to the possibility that the actual experience of Dutch consumers with credit card surcharges is one of price-gouging, rather than a legitimate effort to recoup merchant costs. *See* Wilko Bolt, Nicole Jonker, & Corry van Renselaar, *Incentives at the Counter: An Empirical Analysis of Surcharging Card Payments and Payment Behaviour in the Netherlands*, 34 J. BANKING & FIN. 1738, 1740 (2010) [hereinafter Bolt, *et al.*]. The ubiquity of the practice of above-cost surcharging is discussed in greater detail below, and likely explains much of both the merchant enthusiasm for being allowed to impose surcharges and the consumer opposition thereto. *See infra* notes 172-189 and accompanying text.

[113] *See id.*

(cont.)

irrelevant to the question of whether surcharging is more effective than cash discounts at altering consumer behavior.

The IKEA Non-Study

The BLE brief also offers up the experience of Swedish furniture discounter IKEA to support their claim that surcharging leads to decreased credit card usage.[114] According to IKEA, in 2004 it experimented with imposing a surcharge of a fixed 0.7£ on credit card payments in its United Kingdom stores, which resulted in 37 percent migration of credit card transactions to debit. In a separate experiment in 2010, in the United States, IKEA provided customers who used PIN debit a 3 percent price discount on their *next* trip to IKEA—thus providing *no* discount on the *current* purchase. Unsurprisingly, this offer proved less effective than the UK surcharge experiment, resulting in only 9 percent of consumers opting for PIN debit instead of credit or signature debit.[115]

That imposing a cost on the use of a particular payment device led some consumers to switch to alternative payment devices is neither surprising nor particularly relevant to the underlying question presented by the surcharging cases. Increasing the price of a good or service—in this case, by surcharging credit card transactions—will always decrease demand at the margin. At the same time, it is equally obvious that providing a discount will result in some *increased* demand for use of the discounted product. In order for the these predictable results to have any bearing on the "surcharging has a greater effect on consumer conduct" claim presented by those challenging state no-surcharge laws, however, evaluation of the *relative* effectiveness of these different practices is required.

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[114] Ikea's findings are reported in Scott Schuh, *et al.*, *An Economic Analysis of the 2010 Proposed Settlement Between the Department of Justice and Credit Card Networks* 26-27, Fed. Reserve Bank of Boston, Public Policy Discussion Paper No. 11-4 (2011) [hereinafter Schuh, *et al.*]. As will be discussed, it is highly misleading to refer to the Ikea findings as a "study" in light of the lack of any effort to provide any sort of experimental controls in any fashion.

[115] Indeed, it is somewhat surprising that even 9 percent of consumers saw this as a valuable offer to gain a modest 3 percent discount in a future trip, especially if the consumer would otherwise earn rewards from using his or her credit or signature debit card on their current trip.

(cont.)

But on the question of whether surcharging or discounting is more effective at leading consumers to change payment devices, the IKEA experiments provide precious little evidence to go by.[116]

As the authors of summary of the IKEA experiment observe, with perhaps unintended understatement, "The surcharge and discount results *are not exactly comparable* because of the different countries and time period." Yet even so, they go on to conclude that "[the findings] generally support the notion that consumers respond more to surcharges than to discounts."[117]

In fact, the results are not *remotely* comparable. Not only are they separated by six years (including in the interim, among other things, several elections and a massive worldwide financial crisis), as well an ocean, they follow from entirely different sorts of conduct. While the surcharge was imposed immediately and at a fixed price, the discount was paid after an indefinite time (if at all), following an additional transaction, and in an amount dependent on the size of the subsequent transaction. There is simply no way to tell from the evidence available whether *comparable* surcharges and discounts would have elicited the same or even similar responses; here, the threatened surcharge and offered discount almost certainly had wildly divergent (and, in the case of the discount, entirely indeterminate) expected values to consumers. All we can tell is the direction of the effects—but, as noted, no one needed these IKEA experiments to know that demand curves slope downward. What we have simply *no way* of knowing is whether the relative *magnitude* of the effects was in any way different because of a so-called irrational "framing bias."

The Experiment of the Behavioral Economics Scholars

At the merits stage of the Supreme Court case in *Expressions Hair Design v. Schneiderman*, a new piece of evidence was introduced into the case for the first time: a brand new behavioral economics survey conducted by a BE Scholar specifically for the litigation, a summary of which was submitted to the Court as part of an *amicus* brief on behalf of a group of BE scholars. The behavioral economists argue that the experiment demonstrates that surcharging is more

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[116] The following is based on the summary of the IKEA presentation provided by Schuh, *et al.*, *supra* note 114, at 27.

[117] *Id.* (emphasis added).

(cont.)

effective at changing consumer behavior regarding credit cards than cash discounting.[118]

In fact, the study unintentionally illustrates the problematic nature of devising policy—much less constitutional doctrine—on the unsteady sands of behavioral economics. In particular, the study and the implications that the experimenters draw from it show the limits of trying to draw inferences about consumer behavior in real-world contexts from the artificial and often unrealistic context of laboratory experiments and surveys.

In the study, the economists recruited 820 participants using Amazon Turk.[119] The participants were assigned to one of two groups and asked to fill out a survey. Each participant was told to "imagine" that they had a credit card and were confronted with one of two possible scenarios. Those assigned to the credit-card-surcharge group were presented with the following scenario:

> Imagine that you have a credit card and $220 in cash in your wallet/purse. You buy food at a convenience store.
>
> The salesperson says it costs $130 if you pay with cash (regular price). If you pay by credit card, there would be a surcharge (an additional fee) of around 3%. If you pay with a credit card, the total cost would be $133.90.
>
> Would you pay by credit card or pay with the $220 in your wallet/purse?

Those assigned to the cash discount group were presented with this scenario:

> Imagine that you have a credit card and $220 in cash in your wallet/purse. You buy food at a convenience store. The salesperson says it costs $133.90 if you pay with credit card (regular price).
>
> If you pay with cash, there would be a discount (reduction in price) of around 3%. If you pay with cash, the total cost would be $130.00.
>
> Would you pay by credit card or pay with the $220 in your wallet/purse?

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[118] *See* BE Scholars Merits Amicus, *supra* note 12 (summarizing survey results).

[119] The experimental design and protocol is available at https://osf.io/brm6u/.

The BE Scholars report that the results supposedly

> were strikingly consistent with prospect theory's predictions, and with the prior research discussed above. Of those assigned to the credit-card surcharge group, 11% chose to pay with credit card. Of those assigned to the cash discount group 18% chose to pay with credit card. Put differently, describing the price differential in terms of a credit-card surcharge reduced preferences to use a credit card by more than one-third relative to describing the price differential as a cash discount.[120]

As an initial matter, it is not clear what the authors mean when they claim that their findings are consistent "with the prior research discussed above." Reviewing their brief, they again cite the finding from the Vis & Toth study that consumers "have a strongly negative reaction to surcharges but not an especially positive reaction to cash discounts."[121] But they inexplicably fail to address or even acknowledge the central findings of that study, suggesting that cash discounting is actually more effective than surcharging at altering consumer behavior.[122] They also cite Thaler's speculations in his 1980 article yet again, but, as we've discussed, that study presents no actual "research."[123]

The authors do cite a number of other studies on topics such as teacher compensation, putting by professional golfers, and general incentives with respect to using credit cards,[124] none of which appears to have direct relevance to how consumers will respond to surcharging versus discounting and, as discussed below, might actually suggest that surcharging makes consumers worse off.

More important, however, the study itself provides a warning to courts about the potential pitfalls of basing policy and constitutional doctrine on experiments such as the one described in the BLE Scholars' *amicus* brief.

A notable red-flag is the extraordinarily—and unrealistically—high percentage of participants in the study who claim that they would switch from credit to cash under *either* "framing" of the communication: 89% with the surcharge, and 82% with the cash discount. Although the experimenters report that the differences

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[120] *Id.* at 10-11.

[121] Vis & Toth, *supra* note 83.

[122] *See id.* at 8, *and supra* notes 78-82.

[123] *Id.*, *and supra* notes 76-82 and accompanying text.

[124] *Id.* at 6-7.

between the two groups are statistically significant, they never pause to consider the realism of those findings and the inferences that can be drawn from them.

To put the matter bluntly, the notion that more than 80% of consumers will switch from credit to cash in the face of a 3% price differential is utterly fanciful, *regardless of how it is communicated*. Reviewing the various studies cited above, the best real-world evidence suggests that consumers *sometimes* switch from credit to cash at rates ranging from as low as 7% up to 25% or 50%—but no real-world study finds a rate of switching anywhere near 82% or 89%.

One strongly suspects that the unrealistically high diversion rates in the study reflect the unrealistic nature of the experimental design itself. First, the study was conducted in a completely artificial, hypothetical environment, where the participant faces one discrete decision: to reject or accept a surcharge or discount. In the real world, however, a consumer's choice context is much more complicated, and consumers are unlikely to be so focused on this one particular element of the transaction. The design doesn't ask consumers to consider the timing of the surcharge/discount, whether they have already shopped or would need to adjust their purchase in response to a new price, whether they might prefer to put some of their items back instead of accepting or rejecting the surcharge/discount on all of their intended purchases, or how much it might cost them (in both time and fees), for example, to collect sufficient cash from a nearby ATM. All of these are factors in real-world decisions, and none of them is reflected in the study's stylized and unrealistic setting.

A larger problem, however, is presented by the most strikingly unrealistic aspect of the survey's design. The experimenters tell the consumer to "imagine" that he or she has $220 in cash and is contemplating a $130 purchase. Yet the assumption that the consumer has $220 in cash is entirely arbitrary—and, more to the point, completely unrealistic. According to a recent study based on data collected in the 2012 Diary of Consumer Payment Choice, the median American consumer carries $22 in his wallet—a full order of magnitude less than postulated by the experiment—and only 8 percent of Americans regularly carry $200 or more in their wallets.[125]

Thus, a more realistic experimental hypothetical would be something like the following: "Assume that you have $22 [not $220] in your wallet and you buy $130

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[125] *See* Greene & Schuh, *Consumers' Holdings and Use of $100 Bills*, *supra* note 22. Only 22 percent of U.S. consumers carry even $100 in their wallet.

in groceries at a convenience store." Under that more realistic framing, of course, we would expect to find a rate of substitution away from cards significantly less than 80%, as only the 8% or so of U.S. consumers who carry more than $200 in their wallets would even be able to consider switching, along with some small portion of consumers willing and able to step out of line to retrieve cash from an ATM (which itself may charge a fee even larger than the amount of the hypothetical price differential).

Under this more realistic scenario, it is easy to see how consumer welfare could be enhanced by prohibiting surcharging, even if cash discounting were still permitted. If consumers have effectively locked themselves into using credit by the time they arrive at the register, a surcharge appears to be a purely opportunistic means of taking advantage of the situation, while a cash discount at least provides those consumers who can take advantage of it with an unexpected benefit, rather than an unavoidable and unexpected fee, and leaves those who can't no worse off than they would have been without a discount.[126]

Experimental economics by its very nature requires researchers to deal in simplifications and to conjure up hypothetical scenarios. But to the extent that researchers create unrealistic conditions for their experiments (such as telling participants to assume that they have 10 times more cash in their wallet than they typically would) the implications that can be drawn for consumers making decisions in a real-world context are extremely limited.[127] Moreover, to the extent

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[126] The imaginary scenario provided by the survey also ignores a potential additional problem that goes not to problems with the survey design, but the conclusions that can be drawn for consumer welfare. The scenario provides information about the size of the surcharge ("around 3%") but also calculates a conversion of that percentage figure into final dollar values ($130 versus $133.90). In reality, however, many consumers may be aware of a surcharge but will not find out how large it will actually be, nor how much it will amount to in actual dollars, until they check out. This could potentially result in consumer confusion in comparing prices between competing offers at two stores if one offers a lower sticker price but adds a surcharge and the other offers a higher sticker price but no surcharge, which could result in a consumer choosing the more-expensive offer. Taking steps to prevent this sort of harmful confusion seems like a plausible state interest.

[127] The limits of real-world implications drawn from laboratory experiments (to say nothing of the sort of survey used here, which is even more attenuated than an actual experiment) are well-known. For example, the best known of the behavioral economics effects—the endowment effect—has been consistently whittled away by studies that have introduced more realism into the initial experiments' stylized settings. Nevertheless, BLE scholars continue to assert the endowment effect as justification for a host of regulatory and legal preferences. *See, e.g.,* Gregory Klass & Kathryn Zeiler, *Against Endowment Theory: Experimental Economics and Legal Scholarship*, 61 UCLA L. REV. 2, 5 (2013):

(cont.)

that these unrealistic assumptions produce policies that can actually harm consumers in a real-world context—such as by exposing consumers to bait-and-switch tactics or heightened levels of confusion—basing policy on unrealistic economic experiments can result in consumer welfare losses.

The Evidence to the Contrary

Actually, Discounting Seems to Be More Effective: The Dutch Study, Redux

Although the evidence that BLE scholars actually cite in support of their argument is largely (if not completely) irrelevant to assessing whether surcharging or discounting is comparatively more effective at altering consumer behavior, there *are* some studies and data that suggest apposite results. Indeed, one of them is the Dutch study discussed above.[128] While BLE scholars do misuse the study's misleading data regarding how consumers feel about surcharging versus discounting, they inexplicably fail to mention one of the study's key findings: that both merchants and consumers in the study report that *discounting* is more effective at changing consumer behavior than is surcharging.

The researchers in the Dutch study surveyed retailers and consumers regarding their personal experiences with surcharging and discounting. The merchants who used discounts reported that 43% of those who were offered a cash discount

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> The empirical support for endowment theory was never perfect. In recent years, experimentalists have published data suggesting that the results of earlier laboratory experiments were not caused by loss aversion but by other factors. By making a few changes to the experimental design—like better training subjects in the auction mechanisms used in the experiments, changing the way subjects were given the items, and modifying the procedures for eliciting choices—to rule out alternative explanations, experimentalist were able to make "endowment effects" that had been observed in the laboratory disappear. Many other researchers have since replicated these results…. These results have led experimental economists and cognitive psychologists to develop alternatives to endowment theory.
>
> The legal literature has not kept up. Legal scholars today still write as if… endowment theory were still one of the most robust results of behavioral economics. Having drawn heavily from experimental literature in the early 1990s, many legal scholars have not since returned to the source. Thus while experimentalists have called into question the thesis that the simple fact of ownership predictably changes people's expressed preferences, legal scholars still write as if it does.

[128] *See* Vis & Toth, *supra* note 83.

(cont.)

refrained from paying with a payment card.[129] At the same time, the merchants who surcharged estimated that 27% of consumers who were informed about the surcharge refrained from using a payment card.[130] From the merchants' perspective, it appears that cash discounting was actually over 50% more effective at inducing consumers to use an alternative to payment cards—a result (if it is reliable) that is squarely at odds with BLE theories.

From the perspective of consumers, the results were similar. Twenty-three percent of consumers claimed that they had been asked to pay a fee for using a payment card,[131] and 8 percent reported that they had been offered a cash discount.[132] Consumers also reported that discounting, not surcharging, was more effective at altering their payment choice: Consumers claimed that they refrained from using a payment card in 38% of the cases in which they were asked to pay a surcharge but refrained from using a payment card in 50% of the cases in which they were offered a cash discount.[133] Again, these results appear to contradict the BLE scholars' assertion that surcharging is more effective than discounting at altering consumer behavior.[134]

Nor are the scholars alone in selectively citing to the Dutch study. In their petition for *writ of certiorari* to the U.S. Supreme Court in the *Expressions Hair Design* case,

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[129] *Id.* at 9.

[130] *Id.* at 8, About 11 percent of merchants in the survey simply impose the surcharge on the consumer without disclosing it. *Id.*

[131] *Id.* at 9.

[132] *Id.* at 10.

[133] *Id.* at 10, 14.

[134] We hasten to add that one also should be cautious of drawing the conclusion that the study definitively demonstrates that discounting is more effective than surcharging at altering consumer behavior. For example, it is not clear that the size of surcharges and discounts were symmetrical, as the survey reports an "average" surcharge size of 3.4 percent while reported discounts ranged from 1 to 10 percent, with no average discount size reported in the survey. *Id.* at 9. Moreover, the study itself is subject to clear limitations. The sample size is small, and of the entire sample only about 10% of merchants (32 companies) ever used a surcharge, and only about 9% offered discounts (28 companies). Only five companies used both surcharges and discounts, and the composition of the type of business of the firms in each category is not the same (and we know little about their size), so overall the study may be comparing apples and oranges. On the other hand, both merchants and consumers consistently report that consumers were more responsive to discounts than surcharges, which provides some degree of internal verification. In general, then, the study's findings should be treated with caution—but such cautions also apply to relying on the study to report (and interpret) the subjective feelings of consumers with respect to surcharging and discounting.

(cont.)

the petitioners also cite to the study's purported findings on consumers' subjective feelings about surcharging and discounting,[135] yet make no reference to the study's primary results that consumers actually respond more effectively to discounts than to surcharges.

Consumers Report That Discounts Matter More: The Phoenix Marketing Research Survey

Further evidence (not offered or addressed by the state law opponents) regarding the relative effectiveness of surcharging versus discounting comes from Phoenix Marketing International, a payments industry consulting firm. For its 2014 Phoenix Consumer Payments Monitor report, the firm conducted an online survey of 4,200 adult consumers about their experiences with surcharging and cash discounting.[136]

Seventeen percent of the respondents in the survey reported that they had shopped at a merchant that posted a notice that they would be charged an additional fee for using a credit card and 22% of consumers reported shopping at a merchant that offered a discount for using cash instead of a credit card.[137] Of those who were presented with a credit card surcharge, 55% reported that they used their credit card anyway, and 45% used another payment method instead.[138] But of those who were offered a cash discount, only 30% still used their credit card and fully 70% switched to another payment mechanism (usually cash).[139]

According to the results of this survey, therefore, cash discounting is almost *twice* as effective in persuading consumers to shift to an alternative payment method than is surcharging. Again, this result is squarely at odds with BLE assertions about how consumers will supposedly behave when presented with surcharges and discounts.

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[135] *See* Petition for Writ of Certiorari, Expressions Hair Design v. Schneiderman, No. 15-1391, 2016 WL 3383878 (U.S. May 12, 2016) at 6. At the merits stage of the case, this finding from the Vis & Toth study regarding consumers' subjective feelings about surcharging and discounting was also cited by the BE Scholars Merits Amicus, *supra* note 12, at 8 and Levitin Amicus, *supra* note 12, at 9, but neither brief discusses nor addresses the central findings of that study with respect to the relative efficacy of surcharging and discounting in changing consumer behavior.

[136] Phoenix Marketing International, *2014 Phoenix Consumer Payments Monitor* (on file with authors).

[137] *Id.*

[138] *Id.*

[139] *Id.*

A Different Story—In Which the Merchants Are Looking Out for Themselves, Not Consumers

The available evidence uniformly contradicts the theoretical claims of BLE and thus the contention that merchants seek the ability to surcharge because it is more effective at redirecting consumers to use alternative payment devices than is cash discounting. Although none of the evidence is without defects, and although there is relatively little of it, what evidence does exist indicates that surcharging is *less* effective than cash discounting at inducing consumers to switch to other payment devices.

So why, then, do merchants insist so adamantly—bringing case after case all the way to the Supreme Court—on having the ability to surcharge? Regardless of its complete lack of evidentiary support, the BLE argument does have a seemingly coherent story behind it, which jibes with conventional wisdom. If, as the evidence suggests, the BLE theory is wrong, what does explain the unequivocal, observed behavior of the merchants who have spent millions of dollars fighting for the ability to surcharge?

Experience in countries where surcharging has been permitted for some time suggests a possible answer: Merchants value the ability to surcharge because it enables them to engage in strategic behavior without bearing the full cost of doing so—exactly the sort of opportunistic conduct against consumers that led networks to include no-surcharge provisions in their network contracts to begin with, and that later led lawmakers to enact legislation that prohibits surcharging by merchants. Surcharging enables merchants to opportunistically advertise one price on the shelf and later ambush the consumer with a higher price at the check-out (especially where the consumer is not a repeat customer). It also allows merchants to opportunistically impose costs on consumers in situations where consumers are constrained in their ability to use any payment device *other* than a card (as when purchasing airline tickets or hotel rooms).

And experience in these countries where regulators have forced card networks to allow merchant surcharging reveals that, when given the opportunity, merchants frequently surcharge well above any reasonable estimate of their cost of accepting payment cards. Instead, they surcharge based on their ability to price discriminate among consumers, impose surcharges in those industries where consumers have limited alternatives to paying with a payment card, and routinely fail to disclose surcharging practices or fees in a timely and adequate manner.

The Economics of Surcharging by Merchants

The merchants in *Expressions Hair* Design contend that because surcharges and discounts are "equal in every way except [their] label," only the labels can explain why a State would want to bar one but not the other.[140] Several of their amici make similar claims.[141]

But, as a functional and economic matter, surcharges and discounts are, in fact, different. In the first, and simplest, place, surcharges *increase* the final price above a benchmark, "reference" price, while discounts decrease it. But even this fails to capture the extent of the real, and not merely rhetorical, differences between them. Consider the full quotation from Cass Sunstein, referenced above and only partially quoted in the merchants' brief:

> **The status quo is usually the reference point**, so that losses are so defined when people are asked, or forced, to relinquish what they now have. But simply through inventive terminology, it is possible to manipulate the frame so as to make a change appear to be a loss rather than a gain, or vice versa. These manipulations occur socially—through the acts and deeds of other people and institutions. Consider a company that says "cash discount" rather than "credit card surcharge." **Or consider a parent who says that for behavior X, rather than behavior Y, a child will be rewarded, as opposed to saying that for behavior Y, rather than behavior X, a child will be punished**.[142]

The important thing to note is that the "reference point" in Sunstein's examples is the *same* point. The child's room is either clean or not clean, regardless of the way the parent frames the consequence; the frame itself does not alter the status quo. And, although not descriptively accurate, it is clear that the price from which either a discount or a surcharge is applied in his hypothetical is also the same: it is the status quo—the reference point.

But, in actuality, the reference point *does* change when merchants choose to discount or surcharge: The "mathematical equivalence" is in the hypothetical

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[140] Pet brief at 6.

[141] *See, e.g.*, Behavioral Economics Scholars Br. 2; Levitin Br. 3, 9; Retail Litigation Center Br. 13, 19; Ahold U.S.A. Br. 19; Frankel Br. 4, 11

[142] Sunstein, *What's Available? Social Influences and Behavioral Economics*, *supra* note 5, at 1312 (emphasis added).

amount of the *difference* between two prices, *not* the starting price from which "price plus surcharge" and "price minus discount" diverge. That is, a merchant must set a *different* base price for discounting and surcharging if she is going to maintain their mathematical equivalence. And this difference matters.

First, it is worth noting that a *price itself* is not speech. The merchant's decision to pick a particular reference price from which the merchant may then impose a surcharge is *conduct*, not speech. Whether economically advisable or not, government regulates prices all the time, and does so without violating the First Amendment.[143]

Second, retailers are not free to choose simply any reference price. Because a merchant's ability to choose a posted price is affected by market competition, it may not be equally feasible for a merchant to set the posted, "reference" price at both amounts necessary to maintain the mathematical equivalence asserted by stylized examples. As a result, surcharging and discounting entail different calculations in order to devise the specific pricing scheme suitable for each mechanism.

Third, the amount of the difference may *not* actually be equivalent. In fact, the evidence suggests that surcharge amounts tend to deviate *more* from the base price than do discount amounts.[144] Surely this alone could account for any evidence (if it existed) that surcharges were "more effective" than discounts at changing consumers' behavior.

And fourth, as noted above, a surcharge is manifestly *not* the same as a discount from the consumer's perspective. When a consumer is met at the register with a *higher* price than that posted when she selected the store or chose her items (all of a sudden $100 becomes $103) the information conveyed by the posted price becomes inaccurate. While, obviously, a *lower* price at the register because of a discount would also represent a deviation from the posted price, for equally obvious reasons there is no *harm* associated with such a deviation. For the consumer, the difference between the two is not merely rhetorical.

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[143] *See, e.g.,* Expressions Hair Design v. Schneiderman, 975 F.Supp.2d at 445 (noting that "[p]ricing is a routine subject of economic regulation…").

[144] *See infra* The Ability to Charge Supra-Compensatory Prices.

(cont.)

As the Behavioral Economics Scholars' brief in *Expressions Hair Design* argues, discounting and surcharging *could* have different effects on consumer behavior.[145] BLE scholars assert that this difference means that *labels*, and labels *only*, matter. But it is far more straightforward to see that a discount is inherently and meaningfully different than a surcharge, whatever their nominal mathematical equivalence, and that the difference is not simply a function of how they're labeled but rather how they are devised, implemented, and disclosed by merchants, and how they are understood by consumers.

As a result of these differences, surcharges enable (and arise from) a particular set of sales and pricing practices not available with discounting. Primarily, surcharges enable merchants to price discriminate when customers are unable to provide an alternative form of payment, or are unaware of the merchants' pricing practices because they are not repeat shoppers. Having invested time in the shopping process, decided to purchase her items, and waited to check out, the customers' marginal cost of duplicating this effort in order to avoid a higher, final price at the register may induce her to accept the higher price-plus-surcharge, even though she wouldn't have done so earlier.

The Ability to Price Discriminate

Standard economics thus provides a better explanation as to *why* merchants seek to surcharge consumer payment card usage instead of providing cash discounts: the ability to surcharge enables merchants to extract economic rents from consumers (and ultimately other network participants) by facilitating more-effective price discrimination among consumers based on their relative availability to switch away from payment cards.

Although discounts and surcharges can be mathematically identical, they are not *practically* identical from the perspective of either merchants or consumers. For merchants, the ability to impose a card surcharge empowers them to "hold up the consumer, who has made the specific investment to come to the store and inspect wares."[146] By contrast, a cash discount is seen by merchants as "a giveaway to

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[145] Although, as we discuss *supra* at The Evidence "Supporting" BLE Claims, all available evidence suggests they are wrong about the *direction* of the likely relative effects)

[146] Bourguignon, *et al.*, *Card Surcharges and Cash Discounts*, *supra* note 20, at 20.

(cont.)

consumers who are already in the shop and have cash."[147] As we have written previously:

> The willingness of a merchant to surcharge, therefore, appears to be only coincidentally related to whether a particular payment system actually costs more than alternatives. Instead, it is more likely related to consumers' price sensitivity for particular payment systems, rather than costs.[148]

For consumers, to the extent that surcharging allows merchants to engage in a bait-and-switch at the register after consumers have shopped and selected products (especially in large retail stores) based on posted prices, a surcharge presents a kind of trap, imposing the threat of higher prices at a moment when their price sensitivity is reduced.[149] For consumers who are unwilling or unable to forego some of their intended purchases, or unwilling or unable to spend the time to select a new basket of goods at lower cost to match available cash, the willingness to pay a surcharge may increase. In effect, the surcharge at the register permits merchants to artificially construct a situation for unsuspecting shoppers in which the switch to an alternative payment (or other form of self-help) is made more difficult.

In this sense, a surcharge permits merchants to engage in price discrimination, imposing higher costs on first-time or one-time shoppers (e.g., travelers) and those with other constraints that decrease their sensitivity to price increases, and transferring the benefits of those price increases to other shoppers and the merchants themselves.

The recognition that surcharging behavior by merchants is driven primarily by merchant price discrimination rather than consumer welfare has been further developed by Jean Tirole, the 2014 winner of the Nobel Prize in Economics, in a recent article co-authored with Helene Bourguignon and Renato Gomes.[150] Bourguignon, *et al.*, develop a model of "payment-method-based price discrimination" that turns on the ability of merchants to extract rents from consumers based on the relative ease with which consumers can avoid a surcharge on the use of a particular payment mechanism.

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[147] *Id.*

[148] Lee, *et al.*, *supra* note 49, at 21.

[149] *See supra* note 23 and accompanying text.

[150] Bourguignon, *et al.*, *Card Surcharges and Cash Discounts*, *supra* note 20, at 13.

In particular, Bourguignon, *et al.*, predict that surcharging will be most common in industries where consumers have less information about a merchant's surcharging policy; in particular industries, such as travel, where consumers engage in infrequent or one-time shopping; or in situations in which consumers have little practical alternative but to use a payment card, such as when buying airline tickets, hotels, and when online shopping. As they argue, "the assumption of imperfect information [by consumers] is the key to understanding why consumers and merchants do not view cash discounts and card surcharges as equivalent."[151]

The OFT made a similar observation in its response to a complaint accusing the British travel industry of abusive surcharging:

> The OFT considers that actual market power is not the primary driver of whether surcharging is introduced or persists within a market. Instead surcharging is more likely to persist where products or services have the following characteristics:
>
> - consumers make infrequent purchases
> - consumers incur search costs to discover the surcharge
> - the product and/or transaction processes are complex, tailored or not standardised between retailers, and/or
> - the product is time limited or quantity limited.[152]

As with the example of the shopper surprised at the register above, under the OFT's model of expected surcharging, the primary focus is on the knowledge of consumers and their reasonable opportunities to anticipate the surcharge ahead of time, as well as their relative abilities to avoid surcharges. According to the OFT, this is especially problematic in light of the standard practice of merchants to reveal the size of a surcharge only late in the purchasing process.[153]

Where merchants offer services to tourists or consumers who shop at the store infrequently, for example, merchants have little incentive to provide—and incur the cost of—the desirable amenity of accepting payment cards. Instead, some merchants in these industries may have an incentive to "hold up" consumers by charging them for using a payment card. This threat of hold up is especially

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[151] *Id.* at 19.

[152] OFT PAYMENT SURCHARGES STUDY, *supra* note 21.

[153] *Id.* at 6.

(cont.)

significant when the surcharge is disclosed only at the point of sale,[154] after the consumer has invested (sometimes considerable) time, and which would require the consumer to incur additional costs in order to adjust her purchases or travel to another store and start the process over again of searching for and collecting her desired purchases in order to avoid the price increase. Similarly, with respect to online shopping—where the surcharge is often disclosed only at the final screen of the checkout process—consumers may be reluctant to expend additional time and effort locating and re-selecting purchases from another merchant's site.[155] As Bourguignon, *et al.,* note, it is this incentive for merchants to try to hold up consumers who want to use payment cards that is the origin of network "must-take-card" rules.[156]

The Ability to Charge Supra-Compensatory Prices

Merchants are also not indifferent between surcharges and discounts for another, related reason: The willingness of a merchant to offer a cash discount (in a relatively competitive market) is inherently self-limiting and will be capped by the *actual* cost difference between two payment devices. As long as prices are set in relatively competitive markets, the merchant will maximize revenue at the competitive price (somewhere close to cost for most retail goods), and rarely discount for cash at a rate greater than the actual cost difference between cash and credit.

Surcharges, by contrast, *contain no inherent self-limiting cap*. Instead, a merchant will surcharge at whatever rate will maximize its profits, which will often be a rate that exceeds any reasonable estimate of the cost difference between the two products. In the surcharge case, the amount of the surcharge is a function not of cost, but of the consumer's price elasticity at the time of the surcharge. Merchants will seek to surcharge at the rate that enables them to maximize the rents that they extract from consumers, regardless of the underlying costs. In fact, if permitted, merchants will even surcharge transactions for which payment cards are *less* expensive than cash

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[154] Bourguignon, *et al.*, *Card Surcharges and Cash Discounts*, *supra* note 20, at 19.

[155] For example, according to the UK's Office of Fair Trading, consumers in the passenger transport markets (airlines, ferries, and rail) had to go through four to six web pages before learning that a payment surcharge would be added to the total price. *See Credit Card Charges: The Facts*, THE TELEGRAPH (Dec. 23, 2011), *available at* http://www.telegraph.co.uk/finance/personalfinance/borrowing/creditcards/8974853/Credit-card-charges-the-facts.html.

[156] Bourguignon, *et al.*, *Card Surcharges and Cash Discounts*, *supra* note 20, at 19.

(cont.)

if the merchant can get away with it.[157] Indeed, Bourguignon, *et al.*, observe, that the merchant will always tend to "overshoot" the surcharge relative to the economically efficient surcharge level "in order to extract more rents from consumers" and will always tend to "undershoot" the size of a cash discount because it essentially amounts to a "gift" to consumers who were already planning to make a purchase and then are presented with a lower effective price at checkout.[158]

As a result, surcharges create opportunities for merchants to charge supra-compensatory prices by increasing surcharge rates beyond their costs of accepting credit cards. Many customers will simply pay the additional amount because they have no viable alternative to paying with a credit card by the time they learn of the surcharge. And the customer will often incorrectly believe that the additional fees are the fault of the credit-card company, and not the merchant—i.e., that the merchant is just "passing it on."

To return to the mattress-store example above,[159] the consumer will decide to shop at Store A because its advertised price ($1,000) is lower than Store B's ($1,030), and the consumer does not have information about either store's surcharging practices. Once there, the consumer (carrying less than $1,000 in cash) often minimizes her own costs by simply paying the surcharge, rather than terminating the transaction and beginning anew at another mattress store. Knowing this, the store can maximize its profits by setting the surcharge rate *just below* the consumer's threshold for continuing with the transaction. That rate may be far in excess of the store's cost of accepting credit cards, and, in any event, will bear no necessary relationship to that cost—the recovery of which is ostensibly the reason for imposing the surcharge.

Cash discounting, by contrast, does not facilitate such pricing practices because market competition operates more effectively to ensure that cash discount rates reflect a merchant's actual costs of card acceptance. Consequently, a merchant generally will not be able to use cash discounts to extract above-cost profits because doing so would require the merchant to *advertise* the supra-compensatory price. And in a competitive market, advertising a higher price will disadvantage the merchant, as competitors with similar marginal costs can advertise lower prices.

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[157] *See* Bolt, *et al.*, *supra* note 112 (noting that Dutch merchants impose surcharges on card transactions even for transactions where cards are less costly to the merchant than cash).

[158] Bourguignon, *et al.*, *Card Surcharges and Cash Discounts*, *supra* note 20, at 21.

[159] *See supra* note 23, and accompanying text.

Further, a merchant has no economic incentive to offer a cash discount that exceeds the amount of its cost of accepting credit cards. To do so would generally erode the merchant's profit margin. Thus, while cash discounts will, as a practical matter, rarely exceed the actual cost difference between two payment devices, surcharges lack this inherent limitation.

Here again, the real-world experience in other countries confirms that surcharges facilitate above-cost pricing. As noted above, researchers have found that Dutch merchants routinely surcharged at rates that substantially exceeded the actual cost differential between cash and credit payments.[160] Another investigation in 2016 found that many British merchants imposed surcharges between 1 and 3 percent, even though the marginal cost to British merchants of credit card transactions was between 0.3 and 0.6 percent.[161]

Australia has had the same experience, and one study found that Australian businesses "embraced surcharges as a new revenue stream."[162] The central bank's own analysis also found that "surcharge levels on some transactions appear to be well in excess of merchants' likely acceptance costs."[163] As a result, the central bank and the Australian government have had to adopt further reforms in an attempt to regulate what it deems "excessive surcharging."[164]

What Economics Predicts: The BLE Theory May Align With Practice in the Abstract, But Not in the Particulars

Thus, it is not surprising that when merchants are given the choice between offering discounts or surcharges they almost uniformly choose to impose surcharges. For example, Bolt, *et al.*, find in their survey of Dutch merchants that

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[160] *See* Bolt, *et al.*, *supra* note 112, at 1740.

[161] *See* James Daley, *Why Are We Still Being Charged for Paying By Credit Card?*, FairerFinance.com (Aug. 11, 2016), http://bit.ly/2gE4j41; *see also* OFT PAYMENT SURCHARGES STUDY, *supra* note 21, at 38.

[162] *See Credit Card Surcharging in Australia*, CHOICE REPORT (2013) 8, *available at* http://www.fairtrading.nsw.gov.au/biz_res/ftweb/pdfs/About_us/Credit_card_surcharges_part1.pdf [hereinafter, "CHOICE REPORT"]; *see also* OFT PAYMENT SURCHARGES STUDY, *id.* at 12-13.

[163] Reserve Bank of Australia, *Review of Card Payments Regulation: Conclusions Paper* at 30 (May 2016), *available at* http://www.rba.gov.au/payments-and-infrastructure/review-of-card-payments-regulation/pdf/review-of-card-payments-regulation-conclusions-paper-2016-05.pdf.

[164] *Id.*

(cont.)

about 22 percent of respondents practice credit card surcharges while none offer discounts.[165]

This disparity is striking in light of the fact that, as discussed above, other studies of Dutch merchants and consumers suggest that discounting may be more effective at persuading consumers to switch to cash or other payment devices. Indeed, it seems more accurate to conclude that merchants prefer surcharges to discounts precisely because consumers who are surcharged are *less* likely to switch to alternative payment devices (such as cash), thereby enabling merchants with a greater opportunity to extract rents from consumers. Discounts, by contrast, offer merchants no similar strategic options.

If this view of surcharging is correct, the level and distribution of surcharging practices by merchants should be only coincidentally related to the actual cost difference between cash and cards in various industries. Surcharging should be most common in industries where the potential for opportunism is greatest, such as those industries where consumers make infrequent purchases (such as restaurants and tourism) or those industries where consumers have few alternatives to cards for making purchases (such as for airline tickets or rental cars).[166] Moreover, it would be predicted that the size of the surcharge would also be only coincidentally related to any underlying cost difference between them. And, further, we should expect merchants to hide surcharges (but not discounts), and reveal them only when doing so would necessitate the consumer incurring additional costs sufficient to induce them to absorb the surcharge.

By contrast, if the BLE hypothesis is correct, then surcharging should be more or less randomly distributed among industries. It should be closely related to the actual cost difference between different payment devices. And it will be posted up-front, exactly as a cash discount would be—precisely because the BLE theory is one that turns on disclosure *per se*, not the timing of disclosure or other conduct with which it might be associated.

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[165] Bolt, *et al.*, *supra* note 112.

[166] *See* Lee, *et al.*, *supra* note 49.

(cont.)

The Evidence Points Toward the Economic Story, Not the BLE One

Although there appear to be no comprehensive studies of surcharging behavior across industries, available evidence shows that both surcharging and abusive surcharging (above-cost) behavior appears to be most common in industries where the opportunity for price-discrimination-based surcharging is greatest, such as "air travel, holiday travel, restaurants, taxis, and gas stations."[167]

A 2012 European Commission analysis of practices in the European Union found that Ireland had the highest rate of surcharging by merchants generally, with 15 percent of merchants imposing surcharges.[168] Throughout the EU, only three countries reported a share of merchants that imposed surcharges of above 10 percent (Ireland, UK, and Netherlands). On the other hand, "[t]he travel/hotel sector was notably prone to surcharging.[169] The average proportion of surcharging merchants added up to 26.9 percent in the United Kingdom and 34.8 percent in Ireland.[170] Airlines, especially low-cost ones, are also particularly adept at 'surprising' their customers with card surcharges at the point of sale."[171]

The UK's OFT has done extensive research on the practice of merchant surcharging and has found widespread above-cost and poorly disclosed surcharging practices in the country's passenger travel industries, where there are few alternatives to card payments for purchasing tickets.[172] According to OFT, consumers spent about £300 million in card surcharges in 2010 in the airline sector alone.[173]

In fact, some UK airlines and train lines impose costs for using credit cards as high as 7% (for Jet2) or 4.5% (for Rail Easy).[174] An investigation by the British consumer group Fairer Finance in 2016 found that even though the cost to British merchants of credit card transactions was no higher than 0.6% and in most instances no higher

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[167] Bourguignon, *et al.*, *Card Surcharges and Cash Discounts*, *supra* note 20, at 22.

[168] *Id.* at 16 (reporting results of European Commission).

[169] *Id.*

[170] *Id.*

[171] *Id.*

[172] *See* OFT PAYMENT SURCHARGES STUDY, *supra* note 21.

[173] *Id.*

[174] *Id.* at 38 Table 6.2.

(cont.)

than 0.3% (the maximum interchange fee allowed under a new EU regulation), at that time many merchants were still imposing surcharges of 1%, 2%, or even 3%.[175] As expected, airline companies were overrepresented on the list of companies that charged the highest surcharges.[176] Many government entities have imposed surcharges of 2% or more for paying with a card—and this practice persisted despite a 2012 regulation that limited permissible surcharging fees to the actual cost incurred by the merchant.[177]

Needless to say, none of these rates bear the slightest resemblance to any cost differential between credit cards and alternative payment devices.

OFT also found that abusive surcharging was more prevalent in online shopping—again a market where it is difficult for consumers to purchase goods without using a payment card and where merchants can delay the timing of surcharge disclosures until late in the shopping process. Thus, as OFT observes,

> Surcharging is also more prevalent online than offline.... [O]nline retailers may be more likely to surcharge simply because consumers do not have the option to pay with cash. If in-store retailers attempt to surcharge, consumers are often able to switch to paying with cash. Online, the lack of choice (without incurring the time or financial costs of applying for niche payment mechanisms) means consumers often have no choice but to pay the surcharge particularly if they consider all online retailers have similar practices and/or if they have to invest significant time tailoring products on a number of websites in order to discover the surcharges.[178]

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[175] *See* James Daley, *Why Are We Still Being Charged for Paying By Credit Card?*, FAIRERFINANCE.COM (Aug. 11, 2016), http://www.fairerfinance.com/business/blog/why-are-we-still-being-charged-for-paying-by-credit-card. Fairer Finance was founded by James Daley, the previous director of the campaign at Which? that petitioned the UK's Office of Fair Trading to investigate excessive surcharging fees.

[176] *See Red Card for Card Charges*, FAIRERFINANCE.COM, *available at* http://www.fairerfinance.com/campaigns/red-card-for-card-charges.

[177] *Id.* This leaves aside the fact that as Bourguignon, *et al.*, demonstrate, surcharging should not be permitted when interchange fees are capped by regulation. *See* Bourguignon, *et al.*, *Card Surcharges and Cash Discounts*, *supra* note 20, at 25.

[178] OFT PAYMENT SURCHARGES STUDY, *supra* note 21, at 27-28.

(cont.)

This pattern of surcharging is not unique to the EU or UK. In Australia, a comprehensive regulatory package imposed by the Reserve Bank of Australia in 2003 imposed new price controls on credit card interchange fees, while, at the same time, permitting merchants to impose surcharges on credit card use.[179] The reaction of merchants was swift and predictable. Qantas Airlines, for example, imposed a whopping surcharge of 5.6% of the cost of a transaction, a fee that far exceeds any estimate of the actual cost of accepting card payments.[180] This cost disparity is especially striking in light of the fact that the underlying interchange fee had been slashed as a result of the same regulation.[181] More generally, every airline in Australia imposed a surcharge, and the size of the surcharges varied substantially—and none bore any relationship to relative costs.[182]

A consumer survey conducted by Choice, a prominent consumer rights organization in Australia, found that, by far, the most common industry in which consumers report having seen surcharges was airlines (63.8% reporting seeing surcharges), followed in order by telephone/mobiles/Internet, holiday travel, restaurants/formal dining, taxis, and petrol—all industries for which at least 20 percent of consumers witnessed surcharging.[183] Other industries such as groceries, appliances, insurance, clothing/footwear, fast food, and others all surcharged much less frequently.[184]

As should be readily apparent from this list, a pattern emerges where industries that surcharge are those—such as airline tickets, hotels, and formal dining restaurants—where consumers often find it difficult or virtually impossible to avoid paying with a payment card, or where they are unlikely to be repeat customers. These are exactly the conditions under which merchants have ample

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[179] *See* Keith Bradsher, *U.S. Looks to Australia on Credit Card Fees*, N.Y. TIMES, Nov. 25, 2009, available at http://www.nytimes.com/2009/11/25/your-money/credit-and-debit-cards/25card.html?_r=1.

[180] *See id.*

[181] As Bourguignon, *et al.*, observe, where interchange fees are capped by regulation, such as debit cards in the United States after the passage of the Durbin Amendment, surcharging is almost economically unjustified as the interchange fee cap eliminates any relevant price difference for which surcharging might otherwise be arguably justified. Bourguignon, *et al.*, *Card Surcharges and Cash Discounts*, *supra* note 20, at 23-24.

[182] *See* CHOICE REPORT, *supra* note 162, at 17-18.

[183] *Id.* at 11.

[184] *Id.*

(cont.)

opportunity to holdup consumers with surcharges. In addition, the Choice survey found that close to half of Australians who reported paying a credit card surcharge claim that they were not offered or made aware of an alternative, surcharge-free, payment method.[185] In many instances where surcharge-free methods are made available, they are often so cumbersome or impracticable as to be unrealistic—such as buying a ticket and paying in cash at the airline's airport ticketing counter.[186] Similarly, a stay of even a few nights in a hotel can result in charges of several hundred dollars, a bill that is difficult to imagine paying in cash, especially given that the consumer is typically away from home.

Thus, in these circumstances there are few alternatives to using payment cards, a reality that hotels can and do exploit by imposing surcharges on customers.[187] Business travelers may also be more willing to pay surcharges for items such as airline tickets, hotels, and car rentals as well, as those costs would typically be reimbursed by their employer.[188] Similarly, abusive, above-cost surcharging appears to be more prevalent in online shopping, where consumers again have little alternative but to use a credit or debit card.[189]

A Further Note on Patterns of Abusive Surcharging

Bolt, *et al.*, found a similar dynamic of above-cost surcharging in the Netherlands. On average Dutch merchants imposed a surcharge of about 2.3% on all card transactions, both debit and credit combined—a rate that was higher than most credit card interchange fees, much less debit card fees, in Holland at that time.[190] Moreover, they also found that while some merchants surcharge all card transactions and some do not surcharge at all, many merchants that surcharge do so on those transactions that fall below a certain level—EUR 10 on average.[191]

That many merchants continued to surcharge on transactions below the EUR 10 "threshold amount" identified by Bolt, *et al.*, suggests that many merchants were

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[185] Bourguignon, *et al.*, *Card Surcharges and Cash Discounts*, *supra* note 20, at 18 (describing CHOICE REPORT findings).

[186] CHOICE REPORT, *supra* note 162, at 18-19.

[187] *Id.* at 14.

[188] *Id.*

[189] See Reserve Bank of Australia, A Variation to the Surcharging Standards: A Consultation Document (2011).

[190] *See* Bolt, *et al.*, *supra* note 112, at 1740.

[191] *Id.*

actually surcharging transactions for which card payments were actually *less expensive* on average than cash. The authors report that the EUR 10 threshold was set many years ago and was based on the idea that, from the merchant's perspective, there is a break-even point for the relative cost efficiency of cash versus card payments. For example, whether it is efficient to use cash or a card depends on a variety of factors, such as the prevailing wage rate in an economy (cash handling and transportation is highly labor-intensive and thus cash payments are relatively more expensive where wage rates are higher), the speed, cost, and reliability of a country's telecommunications technology (card payments are relatively less expensive when telecommunications are inexpensive and fast), and the crime rate (more crime raises the costs of acquiring, using, and handling cash).[192] The merchants' decision to set the threshold at EUR 10 reflects a several-years old estimate of the break-even point (at that time) between the cost of cash and cards.

Yet as Bolt, *et al.,* note, this break-even point has changed dramatically over time as the cost of card payments has declined. Whereas the prior break-even point might have reasonably been estimated at EUR 10, the average break-even point is lower than that today.[193] Nevertheless, many merchants still surcharged on any transaction under EUR 10—suggesting that they are surcharging on transactions where payment cards are actually *less* expensive than cash. The authors note further that this may underestimate the full harm to consumers from opportunistic surcharging: In order to avoid paying the surcharge some consumers might instead purchase additional items to bring their purchase amount above the minimum size, an alternative way for merchants to extract consumer surplus (notably, at the expense of other merchants, of course).[194]

As a result of this strong tendency for merchants to impose excessive surcharging fees, regulatory agencies in these countries (as well as in the European Union) were

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[192] *See* Todd J. Zywicki, *The Economics of Payment Card Interchange Fees and the Limits of Regulation*, ICLE Financial Regulatory Program White Paper 2010-1 (June 2, 2010) (describing factors that establish the relative efficiency of different payment devices), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1624002.

[193] Bolt, *et al.*, *supra* note 112, at 1739.

[194] *Id.* at 1740.

(cont.)

forced within a few years to revisit those industries with still further complicated interventions designed to restrain excessive surcharging behavior.[195]

In addition, providing the merchant with unilateral authority to surcharge can also enable the merchant to discriminate between third-party credit cards and the merchant's own store-brand credit card. Target, for example, already provides a 5% discount every day for customers that use Target's proprietary REDcard, notwithstanding that payments using the REDcard are almost by definition not 5% less-expensive for Target once credit loss costs and administrative costs are considered.[196]

In fact, Target's ongoing experience with discounting for its REDcard provides indirect evidence that consumers *do* respond to discounting between different payment devices, especially among otherwise close substitutes, such as a Target credit card and a bank-issued credit card (both of which alleviate the need for consumers to carry large amounts of cash in their wallets). In 2010, Target first introduced its 5% discount every day for shoppers using the Target REDcard. In response, the penetration of the card grew from 5.9% of American consumers in 2009 to 19.3% in 2013.[197] Moreover, Target discovered that REDcard customers visit twice and often as other customers and spend about 50% more.[198] By 2015, REDcard accounted for 22.3% of Target's retail sales, a three-and-a-half-fold growth from the period prior to the 5% cash-back deal.[199] Industry analysts attribute this entire growth to Target offering the 5% discount on all purchases made using REDcard.[200] As one industry analyst wrote, "[A] key milestone for Target was the national launch of the 5% savings feature in the fall of 2010. It was a bold decision and fundamentally changed the trajectory of REDcard penetration.... Aside from the Starbucks Card, there is probably no greater proof

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[195] *See infra* note 207.

[196] *See* Zywicki, *supra* note 192.

[197] *See Growing REDcard Penetration, Improving Online Sales and Smaller Stores Likely to Drive Target's Revenue Per Square Feet,* NASDAQ.COM (Apr. 1, 2014), http://www.nasdaq.com/article/growing-redcard-penetration-improving-online-sales-and-smaller-stores-likely-to-drive-targets-revenue-per-square-feet-cm340660.

[198] *Id.*

[199] John Grund & Jeff Kalsi, *A Look at the Evolution of Target's REDcard Product Suite*, FIRST ANNAPOLIS NAVIGATOR (May 2016), http://www.firstannapolis.com/articles/a-look-at-the-evolution-of-targets-redcard-product-suite?status=success.

[200] *See id.*

(cont.)

that U.S. consumers will adopt a different, largely unproven product if the incentive to do so is rich enough."[201]

The Effects on Regulation

The phenomenon of above-cost surcharging is not only common, it is virtually universal where surcharging is permitted.[202] But it bears repeating that the practical consequences of discounting and surcharging are not identical for consumers and merchants. *And they are not identical for regulators either*. As noted, permitting cash discounting is inherently self-limiting in that the merchant will never discount at a rate that is larger than the estimated cost difference between different payment devices. Permitting surcharging, by contrast, further requires maintenance of a regulatory apparatus and enforcement regime to police above-cost surcharging, and a mechanism for establishing the cost differentials between different payment devices in order to restrict the merchants' inevitable efforts to unfairly extract rents from consumers by imposing above-cost surcharges.

This distinction suggests why policymakers and enforcement officials might legitimately prefer rules that permit cash discounting but prohibit credit card surcharging. In fact, virtually every country that has permitted surcharging has later had to revisit the issue to establish new rules to address the ubiquitous problem of above-cost surcharging, including Australia[203] and the United Kingdom.[204] As the Reserve Bank of Australia observed when it opened consideration of new regulations to restrict abusive surcharging practices,

> In recent years… some surcharging practices that potentially distort price signals—such as surcharging in excess of card acceptance costs—have become more widespread.[205]

In particular, as noted above, in certain industries Australian consumers have increasingly been harmed by ubiquitous excessive surcharging fees on card

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[201] *Id*.

[202] *See infra*, What Economics Predicts: The BLE Theory May Align With Practice in the Abstract, But Not in the Particulars, p. - 50 -, ff.

[203] *See* Reserve Bank of Australia, *supra* note 189.

[204] *See* OFT PAYMENT SURCHARGES STUDY, *supra* note 21.

[205] *See* Reserve Bank of Australia, *supra* note 189.

(cont.)

payments that far exceed any reasonable cost recoupment.[206] In some instances, in fact, Australian merchants imposed surcharges that exceeded their actual cost by 2,670%.[207] We are unaware of any complaints by consumers in any country that complain of merchants discounting cash payments by 2,670% greater than the cost differential between cash and cards.

Experience in other countries suggests, therefore, that surcharging will not be uniform across all merchants in the economy but some merchants will have a differential ability to extract consumer rents through surcharging than others. This suggests, in turn, that merchants that can more effectively surcharge consumers will have a new revenue stream open to them as compared to merchants in industries that cannot surcharge.

For example, if online merchants can impose surcharges more easily than bricks-and-mortar merchants, then surcharging merchants can lower posted prices and capture higher volumes, requiring competing merchants who charge a single price, or who only discount for cash, to meet their prices—but not make up for lost revenue with surcharges. And while it might seem that, whether intentionally or not, this effect would also benefit cash customers who otherwise subsidize payment card customers, in reality the supposed cross-subsidy from cash to credit customers already is not as large as commonly believed.[208] In addition, while higher-income households may be more likely to have credit cards, they may also be more likely to have ready access to greater amounts of liquid cash, enabling them to avoid surcharges more easily for more-expensive products.

But more important, to the extent that enabling some merchants to differentially extract rents from consumers ends up making payment cards less attractive overall, the end result will be to reduce the value generated by the entire credit card network to consumers, merchants, issuers, and society alike (as there are social costs to widespread use of cash, such as increased tax evasion and crime facilitation). For merchants, however, the effect will be uneven: Those that can recoup through

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[206] *See* CHOICE REPORT, *supra* note 162, at 18.

[207] *See* Andy Kollmorgen, *Are You Being Charged to Charge?*, CHOICE.COM (Oct. 10, 2014), https://www.choice.com.au/money/credit-cards-and-loans/credit-cards/articles/excessive-credit-card-surcharging-update. In May 2013, for example, Choice confirmed that Australian airlines were imposing surcharges ranging from 4.2% to 17% on airline tickets bought using a credit card, which made the total merchant service fee markups between 339% and 2312%. Choice also reported that Cabcharge, a taxi service, imposed a surcharge of 11% for using a card. *Id.*

[208] Lee, *et al.*, *supra* note 49, at 24-28.

(cont.)

surcharging will gain the full benefit of the surcharge but will impose the costs on all merchants, bearing only a small fraction of the costs themselves.

If surcharging is applied primarily to extract rents from consumers who have little alternative but to pay with a card rather than to recoup costs,[209] then while this might create some downward pressure on interchange fees (as some lower courts have claimed) there is no reason to believe that much if any of the revenue generated from surcharging will be refunded to consumers, nor is there any reason to believe that much of the savings provided to merchants from lower interchange fees or greater use of cash is passed on to consumers, either.[210] Thus, if merchants are permitted to surcharge credit card payments, consumers could end up paying more to use their cards while receiving little or no offsetting benefit in the form of lower retail prices. More specifically, the increase in credit card charges could be larger than any offsetting price reduction at the register—and this effect could extend to other merchants, affecting consumers everywhere (and not just at those stores that adopted surcharging). Instead, merchants that are better able to opportunistically target groups of consumers for price discrimination will profit at the expense of those merchants that are less able to do so, as well as at the expense of consumers generally.

The Consequences for Information Disclosure and Disclosure Regulation

Private Incentives to Convey Accurate Information

In a related fashion, the (incoherent) behavioral theory of bundling and unbundling prices points out yet another problem with the BLE theory of consumer behavior in general and consumer response to surcharging in particular. For example, in a recent and lengthy blog post on the *Expressions Hair Design* case, Professor Jane Bambauer (one of the signatories to the First Amendment Scholars Merits Amicus)

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[209] *See* discussion *supra* at text accompanying notes 202 to 209.

[210] *See* Zhu Wang, Scarlett Schwartz, & Neil Mitchell, *The Impact of the Durbin Amendment on Merchants: A Survey Study*, 100 FEDERAL RESERVE BANK OF RICHMOND ECONOMIC QUARTERLY 183 (2014); *see also* Todd J. Zywicki, Geoffrey A. Manne, & Julian Morris, *Price Controls on Payment Card Interchange Fees: The U.S. Experience*, George Mason Law & Economics Research Paper No. 14-18 (June 4, 2014); Allen Rosenfeld, *Point-of-Purchase Bank Card Surcharges: The Economic Impact on Consumers*, New America Foundation Asset Building Program Issue Brief (May 2010).

invoked behavioral economics to support the Petitioners' arguments by claiming, among other things, that an "unbundled" surcharge benefits consumers:

> The next way one might try to rationalize the anti-surcharge laws is to suppose that consumers are well-served by seeing one sticker price that reflects the most they will have to pay at the cash register. Perhaps New York and the other states with surcharge bans are regulating the way costs are framed for consumers….
>
> This theory cracks with just a little probing. The anti-surcharge laws wind up censoring not just truthful information, but valuable information: specifically, information that disaggregates the costs of the good or service from the costs of the credit card transaction. This information tends to benefit consumers by making them more likely to avoid transaction costs than they would be if the higher price were normalized and the consumer were offered a discount. The behavioral economics literature shows that the anti-surcharge laws have it backwards: they make consumers more likely to use a card, and thus to pay the higher price, in a dual pricing system. As an amicus brief filed by behavioral economists explains, lab experiments confirm that consumers are more likely to avoid a surcharge than to seek a discount. (This is entirely consistent with Kahneman and Tversky's loss aversion work.)[211]

Leaving aside the incorrect claim that "lab experiments confirm that consumers are more likely to avoid a surcharge than to seek a discount"—is "information that disaggregates the costs of the goods or services from the costs of the credit card transaction" *actually* valuable to consumers?[212]

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[211] *See* Jane Yakowitz Bambauer, *Free Speech Challenge to Credit Card Surcharge Law*s, INFO/LAW (June 27, 2016), https://blogs.harvard.edu/infolaw/2016/06/27/free-speech-challenges-to-credit-card-surcharge-laws/.

[212] It is not clear what lab experiments Bambauer has in mind that supposedly "confirm that consumers are more likely to avoid a surcharge than to seek a discount," as the only lab experiment (itself actually only a survey and not a lab experiment) that has ever been done on that topic was the one described in the BE Scholars Merits Amicus, conducted several months after Bambauer's blog post. It seems that what she really means to say is that lab experiments supposedly demonstrate the general presence of an endowment effect bias, but, like other BLE scholars, she appears to unconsciously conflate the existence of the endowment effect with its supposed operation in the context of surcharging versus discounting. Unfortunately, this tendency of adherents of behavioral economics to conflate the findings of surveys and laboratory (cont.)

Bambauer provides no explanation as to why provision of this particular information about this particular cost would be valuable to consumers (although, as we have discussed, it is potentially valuable to *merchants*). Presumably consumers care only about the final cost of the products they buy, including all add-on fees like surcharges. Why would they care (why would it be "salient"?) how much of the price covers card processing as opposed to any other element of the merchant's cost? After all, why stop at just the card-processing component of the price? Is it valuable for consumers to know what part of a price is attributable to the seller's cost of acquiring inputs rather than shipping? Or what part of a price is attributable to import duties rather than transportation costs? Production versus marketing? The imputed cost of free parking and wages for sales clerks or management? The cost of website maintenance? There is no obvious reason why of all of the potential costs of doing business that could be disclosed to consumers, this one—and this one *alone*—is deemed to be particularly useful. Moreover, if consumers would actually find this information useful, that would suggest only that merchants should be permitted to *disclose* the amount of the processing fees they incur, not that they should be permitted to charge a higher price to those who use credit cards.

Moreover, while Bambauer says that the right to impose a surcharge is justified by BLE, other behavioral analyses argue that engaging in two-part or partitioned pricing will actually *increase* consumer confusion, and lead them at times to pay more, not less, than they otherwise would.[213]

Thus, for example, BE and BLE scholars criticize the complex pricing structure of credit cards on the basis that having multiple price points results in consumer confusion and consumer inattention to shrouded fees.[214] Similarly, Oren Bar-Gill claims that one reason that subprime home mortgages spawned consumer confusion was because the mortgage terms disaggregated closing costs into many

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experiments with their speculative application to real-world contexts is seemingly endemic to the field—not to mention that the validity and predictability of the endowment effect is itself open to substantial question. *See, e.g.*, Charles R. Plott & Kathryn Zeiler, *The Willingness to Pay-Willingness to Accept Gap, the "Endowment Effect," Subject Misconceptions, and Experimental Procedures for Eliciting Valuations*, 95 AM. ECON. REV. 530 (2005).

[213] *See* OFT PRICE FRAMES STUDY, *supra* note 245.

[214] *See* Sumit Agarwal, Souphala Chomsisengphet, Neal Mahoney & Johannes Stroebel, *Regulating Consumer Financial Products: Evidence From Credit Cards*, 130 Q. J. ECON. 111 (2015); Bar-Gill & Bubb, *supra* note 253.

(cont.)

different costs, rather than bundling them all together into a final price.[215] Some BLE scholars argue that airlines' use of baggage fees, ticket change fees, and other fees constitute "shrouded fees" that enable airlines to exploit consumers.[216]

None of these theories is supported by empirical analysis, yet they all derive from the same BLE claim that multi-part pricing is harmful to consumers because it increases consumer confusion, increases the potential for information overload, and enables sellers to impose shrouded or non-salient fees in their pricing.

Yet, in other circumstances, BLE scholars claim that consumers are made *better off* by multi-part pricing, supposedly because multi-part pricing increases "price transparency" for consumers. Thus, for example, Oren Bar-Gill has also argued that consumers are harmed by the fact that credit cards inherently provide both transactional and credit services, and that consumer welfare would improve if consumers were required to use separate products for transactions (debit cards) and credit (a personal loan).[217] At the same time, others have argued that the elimination of free checking by banks would improve consumer welfare by unbundling their pricing structure and forcing consumers to purchase the various components of free checking separately, such as overdraft protection or debit card services.[218]

As with other BLE theories, whether certain prices should be bundled or unbundled appears to be essentially in the eye of the beholder, with the only

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[215] *See* Oren Bar-Gill, *The Law, Economics, and Psychology of Subprime Mortgage Contracts*, 94 CORNELL L. REV. 1073 (2009). Oddly, Bar-Gill's theory on this point rests on the notion that this practice of unbundling closing fees is unique to subprime mortgages when in fact it also characteristic of prime mortgages.

[216] *See* Sumit Agarwal, Souphala Chomsisengphet, Neale Mahoney, & Johannes Stroebel, *A Simple Framework for Estimating Consumer Benefits from Regulating Hidden Fees*, 43 J. LEGAL STUD. 239 (2014); *but see* Manne & Zywicki, *supra* note 260, at 573-76 (discussing heterogeneity in airline policies regarding baggage and other fees and explaining observed behavior as the result of seller price discrimination, not exploitation of consumer biases).

[217] *See* Oren Bar-Gill, *Bundling and Consumer Misperception*, 73 U. CHICAGO L. REV. 33 (2006).

[218] *See* Arin H. Smith, *Durbin's Defect: The Impact of Post-Recession Legislation on Low-Income Consumer*s, 89 NYU L. REV. 363 (2014) ("In theory, higher up-front fees could be mitigated by other benefits. For example, Senator Durbin stated that one purpose of the Amendment was to increase transparency in the financial services market, thus empowering consumers to make good financial choices. The idea is that even if banks are forced to raise fees to offset lost revenue on interchange fees, at least the true cost of the cards will be visible to consumers, rather than hidden within retail prices.").

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discernibly consistent thread being that whatever price structure actually predominates in the market must be designed to exploit consumers. As Bambauer's argument illustrates, there is no coherent theory of when price transparency is valuable to consumers and when it is harmful because it creates information overload and shrouded-fee pricing. In fact, a BLE theorist could easily construct a theory as to why merchant surcharging harms consumers by causing confusion and inattention to shrouded fees, much as the UK's OFT has already done. What is the theory of BLE, for example, that says that it is *efficient* for merchants to unbundle the cost of goods from the cost of the payment transaction, yet it is *inefficient* to unbundle closing costs in a mortgage contract?

In jurisdictions that permit credit-card surcharging, merchants that would rather disclose any surcharge as part of their advertised price, whether or not they discount from that price for cash transactions, are placed at a disadvantage relative to merchants that do not.[219] Such a dynamic impairs their incentive and ability to accurately inform potential customers of the full price of their products.

Jurisdictions that permit only cash discounting, by contrast, do not have this dynamic. There, an advertised price is the maximum price that a customer will have to pay, and a merchant has strong incentives to publicize available discounts as a way to entice customers to shop at the store.[220] And, in contexts where most purchases are via credit card (such as online, or for big-ticket items like hotels and airline tickets), the advertised price will be the real price for the vast majority of consumers. Further, to the extent that the advertised price differs from the price for paying in cash, the difference in price redounds to the customer's benefit.

Real-world experience confirms that credit-card surcharges can effectively conceal, rather than convey, information. As Nobel Laureate economist Jean Tirole and his colleagues have observed, a nearly ubiquitous feature of "international experiences with surcharging" is that "card surcharges are only announced at the point of sale, after consumers [have] incurred significant shopping costs."[221] And the British government has documented this phenomenon in online shopping, where surcharges are often disclosed only at the final screen of the checkout

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[219] *See* OFT PAYMENT SURCHARGES STUDY, *supra* note 21, at 28 n.25.

[220] *See* Resp. Br. 50-51.

[221] Bourguignon, *et al.*, *Card Surcharges and Cash Discounts*, *supra* note 20, at 19; *see also* Lee, *et al.*, *Credit Where Its Due: How Payment Cards Benefit Canadian Merchants and Consumers, and How Regulation Can Harm Them* 20-22.

(cont.)

process.[222] Moreover, at least two studies of foreign jurisdictions have found that consumers often learn of surcharges only *after* a transaction has gone through or—even worse—*do not recall being notified of the surcharge at all*.[223]

It is true, as proponents argue, that "states must 'assume that [accurate pricing] information is not in itself harmful, that people will perceive their own best interests if only they are well enough informed, and that the best means to that end is to open the channels of communication rather than to close them.'"[224] But the "information" disclosed by surcharges is not particularly informative, or necessarily "truthful," at all.

As noted above, merchants are not constrained in any way to impose a surcharge amount that corresponds to the merchant's cost of accepting credit cards. Rather, they may use credit-card surcharges to extract additional profits by increasing surcharge rates *beyond* their costs of accepting credit cards, even though the term "credit-card surcharge" implies that the amount of the extra fee is no more than what the merchant itself is charged. Rather than conveying information about the merchants' costs (and it's unclear why consumers would care about these particular costs at all given the multitude of costs that are bundled into a price), surcharges don't necessarily convey anything about underlying prices; rather they convey (at most) the merchant's revenue maximizing price given its ability to price discriminate.

Moreover, because the merchant claims the excessive fee is a "*credit-card* surcharge," the customer will often incorrectly believe that the additional fees *are* commensurate with the merchant's cost and that they are the fault of the credit card company, not the merchant—i.e., that the merchant is just "passing it on." And, as noted, many customers will simply pay the excessive surcharge because they have no viable alternative to paying with a credit card by the time they learn of the surcharge. As noted above, real-world experience confirms this intuition.[225]

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[222] *See* OFT PAYMENT SURCHARGES STUDY, *supra* note 21, at 35 (observing that businesses often do not inform customers of a surcharge until the customer has "gone through four to six web pages, where numerous decisions have to be made to tailor the product and where personal information often has to be provided").

[223] *See* Vis & Toth, *supra* note 83, at 8 (approximately 11% of merchants in the Netherlands reported that they did not inform their customers of the surcharge); CHOICE REPORT, *supra* note 162, at 14.

[224] Pet. Br. at 32-33 (quoting Va. State Bd., 425 U.S. at 770).

[225] *See supra* notes 160-164, and accompanying text.

Regulation of Information Disclosure

Regulators are not indifferent between discounts and surcharging for another reason: Permitting surcharging requires the construction and enforcement of an extensive disclosure regime, whereas permitting discounting does not. As noted above, because surcharging seems to be motivated by a desire by some merchants to extract surplus through holding up consumers at the point of sale, merchants have a strong incentive to minimize the transparency of their surcharges and to reveal surcharges to consumers as late in the shopping experience as possible—typically well *after* a consumer has invested her time in shopping in the store and deciding on a purchase. Doing so minimizes the likelihood that a consumer confronted with a surcharge will simply walk away from the transaction. Disclosure of cash discounting, by contrast, will tend to be self-enforcing: Because discounting is a price reduction to the consumer, the merchant will have a strong incentive to *promote* it to the consumer early and often, thereby eliminating the need for a complicated disclosure regime that could entail significant enforcement costs.

In fact, as suggested above, countries that have allowed surcharging have experienced chronic problems of a lack of transparency by merchants in disclosing their proposed surcharges to consumers. In the United Kingdom, for example, OFT revealed that transportation passengers on airlines, ferries, and trains had to click through an average of 6 pages—and in some cases 8 pages—before a surcharge was revealed.[226]

Where surcharging is permitted, consumers have expressed widespread frustration with respect to the disclosure of surcharging. As an American Express spokesperson in Australia stated, "[t]he number-one complaint we hear from consumers is that they didn't know there was a surcharge until it was too late."[227] Twelve percent of respondents in the Choice survey reported that they did not recall being notified of the presence of a surcharge at all.[228] Of those who were notified, 25.7% felt that the method of notification was not prominent enough and 17.4% said that the timing of the notification was inadequate (including in some

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[226] OFT PAYMENT SURCHARGES STUDY, *supra* note 21, at 36 Table 6.1.

[227] *See* CHOICE REPORT, *supra* note 162, at 14 (quoting Luisa Megale).

[228] *Id.* at 14. This figure is consistent with that reported by Vis & Toth that approximately 11% of the merchants that they surveyed do not tell their customers of the surcharge. *See* Vis & Toth, *supra* note 83, at 8.

(cont.)

instances disclosure only *after* the transaction had gone through).[229] Although these disclosure problems appear to affect only a minority of consumers, the number of people affected is also not zero—again, providing a contrast to cash discounting, for which a merchant has powerful incentives to make shoppers fully aware of the discount and for which lack of disclosure is unlikely to be a problem.[230] Thus, like the self-limiting nature of the size of cash discounts that mitigates the need for the state to police opportunism, cash discounts also appear to have a natural bias toward greater transparency.

In addition, solving the problem of adequate surcharge disclosure is more difficult than it might seem at first glance. In the United States, for example, there are literally thousands of different debit, credit, and prepaid cards, with a wide range of different interchange fees and other costs. Few would think it adequate for a merchant to simply put a sign in the window or on a webpage stating that they reserve the right to impose a surcharge, with no further information, only to finally reveal the size of the surcharge at the time of checkout.

But if a mere notice that surcharging may occur is inadequate, what would be required to accurately disclose the surcharge? Might the merchant simply impose a surcharge based on the average cost differential between all payment cards and cash? If so, then this by definition means that half of consumers will be paying a surcharge fee that exceeds the cost to the merchant. It is hard to see how this benefits consumers to authorize merchants to impose above-cost surcharges on low-fee cards, but below-cost surcharges on higher-fee, premiere cards—the exact cards, it should be noted, that merchants claim they wish to discourage the use of. Alternatively, should merchants be allowed to disclose an average surcharge rate at first and then impose a higher fee on some consumers at the checkout? This hardly seems an equitable practice and still entails the same bait-and-switch we have previously discussed.

The U.S. can learn from the problems experienced in other countries on this point. For example, Australian regulators have long been critical of the practice of "blended" surcharging—namely, imposing a single uniform surcharge amount, perhaps even one based on the merchant's overall average cost of acceptance. As the Reserve Bank of Australia wrote in its latest round of revisions to its

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[229] *Id.* And in other instances, consumers reported that the disclosure was made verbally, and only at the point that the transaction was actually being processed. *Id.* at 15.

[230] Of course, even this assessment leaves aside the fact that 12% of shoppers claim that they never knew of the surcharge at all.

surcharging rules in order to address the problem of abusive surcharging practices by merchants:

> Where a merchant applies a single surcharge across two systems with different acceptance costs and sets the surcharge at the average acceptance cost of the two, the lower-cost system will be surcharged excessively (i.e. above its acceptance costs). This dulls price signals and does not support efficient payment choices.[231]

And while the RBA recognized that this practice of blended surcharging often arises from the merchant's desire for simplicity and desire to avoid keeping track of and processing a myriad of different acceptance costs, the RBA still decided to require that the permitted surcharge rate for merchants could be set only at the lowest acceptance-cost rate among the various card networks that they accept.[232]

Enabling merchants to surcharge opens substantial problems of information provision and disclosure that are much more difficult than advocates of the practice have been willing to consider. Moreover, in many cases, the information asymmetry inherent in such a disclosure regime will overwhelmingly tilt in the merchants' favor, possibly resulting in a reduction of consumer welfare.

Behavioral Economics vs. Behavioral Economics: Conflicting Behavioral Explanations for and Against Surcharging

The BLE theory of surcharging also confronts a substantial and more general problem inherent in BE's effort to apply various biases identified in laboratory experiments to the real world. In many situations various alleged behavioral biases often contradict one another, or have offsetting effects when applied in particular circumstances. Although the reality of this problem is often acknowledged, it is also often merely paid lip-service. Yet the problem is far too severe to be waved away, both in general but also specifically with respect to the effort to apply behavioral economics to predict consumer responses to surcharging and assess whether permitting surcharging will increase consumer welfare.

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[231] Reserve Bank of Australia, *Review of Card Payments Regulation*, *supra* note 163, at 33.

[232] *Id.*

(cont.)

Consider the seemingly simple example of the claim that people systematically fail to save enough for retirement. BLE theorists speculate that this tendency arises from purported biases that lead people either to underestimate how much they need to save for retirement or to lack sufficient self-control to carry through with their desired plans.[233] Yet behavioral economists *also* contend that people suffer from "over-optimism" bias, which supposedly leads them to systematically overestimate their likelihood of living to retirement age, such as by underestimating the likelihood of contracting a fatal disease or dying in an accident.[234] Nor do they have any methodology for determining the strength of these offsetting biases and whether they lead people, on average, to save too much, too little, or just the right amount for retirement. In fact, BLE can be invoked to "explain" any of these behaviors.[235]

These examples highlight the "just-so stories" problem of BLE methodology.[236] The existence of dozens of purported biases with potentially offsetting effects and the absence of a systematic means of reconciling them means that it is possible to explain virtually any consumer behavior—as well as its opposite—by reference to these biases, and to claim that *either* is suboptimal. But a theory that can explain anything is a theory that can predict nothing.

The UK Office of Fair Trading Applies Behavioral Economics to the Same Issue... and Reaches Precisely the Opposite Conclusion

Thus, while there are behavioral theories that purport to provide a justification for allowing merchants to surcharge, unsurprisingly, there are also theories—well summarized by the OFT in a recent report[237]—that explain how *allowing* surcharging can harm consumers by enabling merchants to prey on consumer

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[233] *See generally* Zywicki, *Do Americans Really Save Too Little and Should We Nudge Them to Save More?*, *supra* note 37.

[234] *See id. See also, e.g.*, Justin Kruger & Jeremy Burrus, *Egocentrism and Focalism in Unrealistic Optimism (And Pessimism)*, 40 J. EXPERIMENTAL & SOC. PSYCH. 332 (2004).

[235] *See* Zywicki, *Do Americans Really Save Too Little and Should We Nudge Them to Save More?*, *supra* note 37.

[236] *See* Zywicki, *Just-So Stories*, *supra* note 40.

[237] *See* OFFICE OF FAIR TRADING, ADVERTISING OF PRICES MARKET STUDY (Dec. 2010) [hereinafter UK ADVERTISING STUDY], *available at* http://webarchive.nationalarchives.gov.uk/20140402142426/http:/www.oft.gov.uk/OFTwork/markets-work/advertising-prices/; AHMETOGLU ET AL., OFFICE OF FAIR TRADING, PRICING PRACTICES: THEIR EFFECTS ON CONSUMER BEHAVIOUR AND WELFARE (March 2010), *available at* http://webarchive.nationalarchives.gov.uk/20140402142426/http:/www.oft.gov.uk/shared_oft/business_leaflets/659703/Advertising-of-prices/Pricing-Practices.pdf.

biases. Aptly illustrating the problems with relying on BE for policy recommendations, many of the same biases that American BLE theorists point to as justifying a right to surcharge are precisely the same biases that the OFT points to as leading to potential consumer harm from surcharging, such as framing, prospect theory, and the like. The fact that two different sets of analysts can analyze the exact same issue using the exact same set of purported biases (framing, prospect theory, etc.) suggests how weak is the foundation for a behavioral-based consumer financial protection policy in this context.

The OFT contends that the consumer bias phenomenon explains the ubiquitous tendency of merchants to withhold information from a consumer as long as possible into the shopping and purchasing process, such as by requiring multiple screens when making on an online purchase or by withholding details about the size and specifics of surcharges for retail store purchases. It refers to the practice of disclosing one price at first (the posted price of goods on a shelf) and then raising the price later by imposing a surcharge as "drip pricing," in that the full price is not stated upfront but rather emerges in multiple stages.[238]

According to the OFT,

> by revealing prices at a late stage of the transaction process and separating them from the headline price *a number of behavioural biases are engaged* which also make consumer less willing to shop around for the best price and more likely to underestimate the total price paid.[239]

For example, consumers supposedly suffer from a "commitment and consistency" bias, which means that "people have a desire to be consistent with their previous actions."[240] Thus, "even when the price starts to increase [such as by imposing a surcharge] they tend to remain committed to the retailer."[241] Consumers are also said to suffer from an "endowment effect and loss aversion" bias, which means that "people seem to value a product more once they own or feel like they own it, such that they demand more to give up an object than they would be willing to pay

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[238] UK ADVERTISING STUDY, *id.*

[239] OFT PAYMENT SURCHARGES STUDY, *supra* note 21, at 32.

[240] *Id.*

[241] *Id.*

(cont.)

to acquire it."[242] Thus, "[a]s consumers go through the transaction process, their feelings of ownership increase and therefore so too does their willingness to pay."[243] Consequently, once consumers feel this ownership interest they are more vulnerable to merchants holding them up late in the purchase process by imposing a surcharge in addition to the marked price.[244]

The "endowment effect" bias to which the OFT points as making consumers vulnerable to opportunism in the context of drip pricing (i.e., surcharging) is *exactly the same bias* to which American behavioral law and economics scholars point as *increasing* consumer welfare in the same context:

- For the OFT, when shoppers arrive at the point of payment with a bundle of goods in tow (and money in their wallets and bank accounts), the endowment effect induces them to pay more than they would otherwise (*i.e.,* to accept the surcharge) in order to complete their transaction—in order to keep "their" goods. They would suffer no such harm if the merchant offered a cash discount; rather, they would both keep "their" goods *and* save money, by anticipating the lower price from the start.

- For the American BLE scholars, when shoppers arrive at the point of payment with money in their wallets and bank accounts (and goods in tow), the endowment effect induces them to opt for the lower-cost payment method (*i.e.,* to reject the surcharge) in order to keep more of their money. They would realize no such benefit if the merchant offered a cash discount; rather, they would view the discount as a "gift" of someone else's money, instead of a way to keep what was already theirs, and more readily reject it.

In other words, the concept appears to be so elastic and ill-defined that *exactly the same bias*, *in exactly the same circumstance*, can be relied upon to justify squarely contradictory conclusions. It is hard to see how theories that purport to explain directly contradictory results can provide a useful foundation for law or public policy.

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[242] *Id.*

[243] *Id.*

[244] It is worth pointing out that the "loss aversion" bias is, of course, also the one that behavioral economists point to as supposedly *supporting* the need to allow surcharging.

The OFT also points to the framing effect to explain why surcharging harms, rather than helps, consumers—also in contrast the American BLE scholars:

> Subjects reported in the questionnaire feeling disappointed in this frame because they felt they were receiving a good deal when they saw the base price. *Subjects reported that they still bought the good after they found out the additional charges*, but felt cheated and annoyed because their pay-off was reduced.[245]

And the "anchoring bias" comes into play in contradictory fashion, as well. As the OFT agues:

> [D]rip pricing was also found to increase sales as consumers focus (or "anchor") on the piece of information they consider to be most important, often the advertised prices, and do not fully adjust their calculation of the total price, as additional charges are revealed, thereby overestimating their total value of the deal. The lower up-front price therefore attracts consumers and the first shop (or website) that they visit benefits from higher sales, as some consumers choose not to shop around even when additional charges are revealed."[246]

The OFT also refers to the "behavioural psychology literature" that shows that "simply separating a price into a base price and additional charge, even where they are displayed together, known as 'partitioned pricing,' leads to higher demand and perceived value amongst consumers, as well as a lower recalled price, lower estimation and lower search (shopping around) intentions."[247] All of these biases contribute to the implication that surcharging, might be harmful to consumers because it exploits consumer biases.

Notably, the OFT found that consumers in its experiment were not deterred by a surcharge—that they still paid with a credit card despite the surcharge. But as a result, consumers "felt cheated and annoyed."[248] This finding—that consumers are annoyed at how surcharges are assessed in practice, but nevertheless still use cards because of limited alternatives—could explain how Vis & Toth's study of Dutch

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[245] OFFICE OF FAIR TRADING, THE IMPACT OF PRICE FRAMES ON CONSUMER DECISION MAKING, OFT1226 at 9 (May 2010) (emphasis added), *available at* http://bit.ly/2fLC0RY [hereinafter OFT PRICE FRAMES STUDY].

[246] OFT PAYMENT SURCHARGES STUDY, *supra* note 21, at 33.

[247] *Id.*

[248] OFT PRICE FRAMES STUDY, *supra* note 245, at 9.

consumers could simultaneously find high rates of feelings of annoyance with surcharges but nevertheless low rates of diversion to alternative payment devices.

By contrast, on the American side of the Atlantic, the BE Scholars Merits Amicus (as well as the merchant Petitioners) simply infer that, because consumers are annoyed by surcharges in the Dutch Study, surcharges are therefore more effective. Moreover, these scholars concoct their own just-so story to explain why—even though that very same study actually presented results that should have suggested that *feelings* of annoyance *don't* translate into fewer surcharged transactions.[249]

In fact, the OFT experiment found that drip pricing resulted in, by far, the largest welfare loss for consumers of any of the pricing strategies studied, and that drip pricing resulted in "substantially" more errors by consumers in finding the lowest price of any of the pricing strategies that were examined.[250]

Thus, according to the OFT, a variety of behavioral biases—loss aversion, anchoring, the commitment and consistency principle—suggest that the reason that merchants demand a right to surcharge is actually in order to *exploit* consumer biases. And, crucially, this explanation works only if merchants believe that surcharges will *not* cause a substantial number of consumers to leave the store or avoid using a card. Indeed, consistent with the hypothesis of Lee, *et al.* and Bourguignon, *et al.* that surcharging appears to operate in practice as a rent-extraction device rather than a mechanism to divert consumers to alternative payment devices, it seems that the reason why merchants prefer to surcharge instead of discount is precisely because consumers *won't* switch to cash, not because they *do*.

We hasten to add that this discussion should not be read to endorse the OFT's analysis, either, as its analysis is as speculative and context-dependent as the American BLE scholars' theories invoked in favor of allowing surcharging. The OFT's analysis, however, at least has the virtue of being consistent with the empirical evidence that exists, which suggests that surcharging actually may be less effective than cash discounting at diverting consumers to alternative payment devices.

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[249] BE Scholars Merits Amicus, *supra* note 12, at 3.

[250] *Id.* at 87 Table 5.19: Summary of Main Findings; *see also id.* at 56 Table 5.1: Welfare Losses Under the Different Price Frames (reporting that drip pricing resulted in much larger welfare loss for consumers than any of the "price frames" that were tested).

(cont.)

More generally, however, the reality that behavioral economics can provide "just-so story" arguments both for and against surcharging raises questions about the predictive accuracy of the methodology at all and illustrates the risks of basing policy, much less constitutional doctrine, on speculative methodology and dubious empirical foundations.[251]

Other Behavioral Biases Also Support—Rather Than Refute—Surcharge Bans

These examples provide only a small glimpse into the real difficulty of implementing policies on the basis of behavioral economics claims.

Consider, for example, the trendy BLE notion of "shrouded pricing," an argument that dates to a 2006 article by Gabaix and Laibson,[252] and which has recently been embraced by BLE scholars in the context of credit card pricing.[253] The theory of "shrouded pricing" divides seller pricing behavior into two categories of terms: "salient" terms—those that consumers presumably notice and consider in their purchasing decisions—and "non-salient" terms—those that consumers do not pay attention to.

To illustrate the idea, it has been argued that certain behavior-based fees on credit cards, such as late fees and over-the-limit fees, are non-salient to the consumer shopping decision.[254] Thus, it is implied, credit card issuers can extract rents from consumers by using *those* terms instead of alternate revenue sources that may more-effectively deter consumers from adopting or using cards. Although this hypothesis has been falsified in the credit card context,[255] it nevertheless remains a staple of BLE theory.

A fundamental problem with the theory, however, is its lack of rigor in classifying terms as "salient" or "non-salient." Most notoriously, one leading BLE consumer credit scholar rested the core claim of a 2004 article on the assertion that credit

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[251] *See, e.g.,* Klass & Zeiler, *supra* note 127.

[252] See Xavier Gabaix & David Laibson, *Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets*, 121 Q. J. ECON. 505 (2006).

[253] Oren Bar-Gill & Ryan Bubb, *Credit Card Pricing: The CARD Act and Beyond*, 97 CORNELL L. REV. 967 (2012).

[254] *See id.*

[255] *See* discussion in Durkin, Elliehausen, & Zywicki, *supra* note 33, at 57-63.

(cont.)

card interest rates were non-salient to consumers,[256] only to completely reverse himself in another article approximately a decade later.[257] This switch in position came with little discussion, other than a terse claim, provided with no theory or empirical support, that interest rates simply became salient to consumers.[258]

Similarly, some BLE scholars assert that fees charged for consumer cash advances on credit cards are non-salient, although it is difficult to see why those fees would not be salient at the time consumers take the advance.[259] Moreover, BLE scholars routinely make sweeping claims based on the theory of "shrouded costs" without any consideration of alternative hypotheses or even casual empirical observation that rebuts the claim.[260] The problem is that such concepts are non-falsifiable, malleable, self-contradictory, and, often, trotted out only when convenient.

Thus, although it would seem wholly appropriate to do so, BLE scholars have not described credit card surcharges as shrouded fees—presumably because, as it is currently interpreted, the theory of shrouded fees does not offer the desired result. In the context of surcharging, the theory would seem to suggest that surcharging may be a shrouded fee, as a surcharge is an additional charge that is imposed on top of the base charge for the product being purchased, often (as some of the evidence indicates) without the consumer's awareness. Moreover, the theory would also predict that surcharges would be relatively ineffective at changing consumer behavior at checkout, which would in turn predict that surcharging would be relatively ineffective at altering behavior. And yet (or, more likely, as a result), despite the apparent relevance of the shrouded fees concept to the practice of merchant surcharging, neither BLE scholars nor the merchants citing them make reference to shrouded fees in their analyses.

Conclusion

The BLE arguments underlying the challenges to state anti-surcharging laws in cases like *Expressions Hair Design* are based on weak economic theory and even

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[256] Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373 (2004) (arguing that long-term interest rates are "non-salient").

[257] Oren Bar-Gill, SEDUCTION BY CONTRACT: LAW, ECONOMICS, AND PSYCHOLOGY IN CONSUMER MARKETS (2012) (arguing that long-term interest rates are "salient").

[258] *See* discussion in Durkin, Elliehausen, & Zywicki, *supra* note 33, at 57-63.

[259] *See id.*

[260] *See* Geoffrey A. Manne & Todd J. Zywicki, U*ncertainty, Evolution, and* Behavioral *Economic Theory*, 10 J.L. ECON. & POL'Y 555, 573-76 (2014).

weaker—indeed, incorrect—empirical evidence. Whatever the ultimate legal merits of the First Amendment arguments adduced to challenge these laws, to the extent that those arguments rest on the BLE arguments advanced by the Petitioners (and partially recognized by the lower courts), they are woefully lacking.

The effort to interject behavioral economics into these cases points to a larger issue, however: the still-undeveloped nature of BLE (and BE, for that matter) as a research program, and the dangers of basing law and policy on such an unstable foundation.

The issue of surcharging versus discounting illuminates the problems in dramatic fashion. The entire argument for the purportedly greater efficacy of surcharging versus discounting as a means of changing consumer demand for certain payment mechanisms rests on only a small handful of self-referential papers peddling dubious theory and unsupported speculation. Subsequent papers claimed to provide further support have largely just uncritically cited to these original articles, without adding any new or useful empirical evidence. And, to the extent that empirical evidence does exist, it is weak and inconsistent with the hypotheses, anyway. Moreover, the evidence, such as it is, is selectively referenced and consistently mischaracterized.

Still further, on this issue and many others, BLE, and the behavioral economics literature underlying it, is frequently self-contradictory and riddled with non-falsifiable "just-so" stories that make no effort to consider or test alternative hypotheses. With respect to surcharging, Lee, *et al.*, and, later, Nobel Laureate Jean Tirole, have argued that the best explanation for observed surcharging behavior in practice is price discrimination based on consumers' access to alternative payment mechanisms at the time of payment. Thus, for example, surcharging is most prevalent not where card payment costs are higher; rather, the tendency to surcharge bears no relationship at all to underlying cost, but is more prevalent in markets where it is difficult to use alternative payment devices, such as online shopping, airline tickets, or travel.

Put simply, BLE offers a seemingly logical theory to oppose bans on surcharging—but it fails to comport with the evidence, fails to explain why surcharging occurs more commonly in some markets that others, and fails to explain the abusive surcharging behaviors that have characterized markets around the world where surcharging has been permitted.