



## Episode 1,415: Bad Idea: Bernie and AOC Want to Cap Credit Card Interest Rates

Guest: Todd Zywicki

**WOODS:** You and I were just saying that this is a case of "the man and the moment have met." In a way, it reminds me of the days of the Clinton impeachment, when suddenly, scholars of Andrew Johnson were called upon all over the place to talk about the history of impeachment. There was a great renaissance of interest in Andrew Johnson. And likewise, here, because you of course for a long time have been an expert on the subject of consumer credit, and now we're hearing this proposal from Alexandria Ocasio-Cortez and Bernie Sanders to put a cap on the interest rates that credit card companies can charge, and that's supposed to help poor people. Is there anything to their case, or how do you look at that?

**ZYWICKI:** Well, that is the funny thing about this, Tom, is this is an idea, a bad idea that seems to never die, which is over and over and over, every generation or two, it seems like we have to relearn the painful lessons associated with interest rate ceilings. And we've seen it repeatedly during the 20th century, and it's always ended the same way, because the economics on this is actually pretty simple, pretty straightforward. Price controls don't work, and price controls on credit are really no different from price controls on milk or housing or anything else. And they filter through in different sorts of ways, but it always ends up the same way. But after a while, people forget. They go back to the idea. And it ends tragically, unfortunately, mainly for the most vulnerable, and low-income members of society end up getting hurt the most.

**WOODS:** The logic of it seems to pretty easy to understand, namely that it's not like by capping interest charges on credit cards, that you're improving the credit rating of people. You're not making them people who are more desirable to lend to; you're just taking away options that they would have. Either I can have a high-interest card or no card at all.

**ZYWICKI:** That's right. And when I explain this to people, the way you can think about it is sort of like squeezing a balloon, right? There's a supply of credit, and there's a demand for credit. Nobody has suggested that American credit card markets are anti-competitive or anything like that. We've got, last I saw, 6,000 issuers of credit cards in this country, and that doesn't even include store cards and all those sorts of things. And so you can just think of a supply and demand. There's a certain amount of air in the balloon. You can squeeze on one part, and it pops up somewhere else. And so we could go through all the dynamics of it, but for example, one of the reasons that credit cards used to have annual fees — pretty much every standard credit card at an annual fee — was because we had interest rate ceilings. And eventually what happens, as you alluded to, is you can only move the air around in the balloon so much before it pops, and a lot of people end up losing credit cards and the like and filter down to other products.

**WOODS:** Isn't that funny? It never occurred to me that the annual fee was a way around — it brings to mind to me back in the High Middle Ages when there were prohibitions on usury, there were ways of getting around those. Sometimes they would arrange for someone to, wink, wink, pay late so that then they'd have to pay a late fee. Everybody knew this makes no sense.

**ZYWICKI:** Yeah, that's exactly right. I mean, it's really just supply and demand. So what we end up seeing whenever we impose usury ceilings, especially on credit cards, is there's at least three things that happen. The first thing I call term repricing, which is this point I was just talking about, which is there are literally dozens of different price points on a credit card. So it could be that you impose an annual fee. And note, annual fees are especially regressive. Back in the '70s, you paid the same \$40 annual fee, whether you charged 3,000 a year or 30,000 a year. Note also that, to the extent that if you set interest rates below the market clearing interest rate, what you end up doing is basically making people who pay their bill every month subsidize those who get a lower interest rate than they otherwise would have. But if you look at it, what you see are all kinds of ways in which those prices can filter through.

The second thing that you see is term substitution. So in the 1970s, only about 10 to 15% of American households had credit cards, and that was largely because of usury ceilings. Where most people got their credit from, or middle class people, were from two sources. Mainly from stores, department stores like Sears, JC Penney. The big department stores basically ran their own credit operations. And why did they have so much of the market? Well, credit card issuers could avoid usury ceilings by imposing an annual fee, but Sears was even more clever. All Sears would do would be to charge you a below-market interest rate, which they had to do, and then just mark up the price of the goods that you bought, so that, for example, in Arkansas, which had very strict usury ceilings, the exact same refrigerator cost 8% more in Arkansas than it did right across the border in Texas. And basically what was recognized was that that was a way of burying the credit loss. People always bought refrigerators on credit, and so consumers in states with usury ceilings, strict usury ceilings, got more of their credit from department stores than other places.

We even see this today. There was a recent study done about two years ago. In states with stricter usury ceilings on car loans, car dealers make a larger percentage of the loans than they do in states without. Why? Because car dealers just jack up the price of the car in order to make up for the fact that they can't charge a market rate of interest. States with strict usury ceilings also — so Arkansas was basically the pawn shop capital of America. It had a strict usury ceiling and had about three times as many pawn shops as in other states.

And even after that, the last thing we get to, of course, that we can talk more about, is rationing. And I find it actually quite appalling that in their announcement, Bernie Sanders compared banks today charging 18% on a credit card with the loan sharks and the leg breakers of the past. And that is just irresponsible rhetoric to compare what's going on today with the predation and the brutality that loan sharks inflicted on generations of lower income and immigrant Americans. It just is really irresponsible and appalling. And it then it really downplays what has been a very, very serious problem through history.

**WOODS:** Well, even the term "high-interest rates" just strikes me as arbitrary, because all you're dealing with is people's subjective valuations of the present over the future. And if some people value satisfaction in the present with a great intensity over their satisfaction in

the future, Well, who's to render a moral judgment about that? Maybe that's just how it is. Or likewise, I think, obviously, there are some people who have had terrible credit histories. Nobody wants to lend with them. No one wants to touch them with a ten-foot pole. But there are one or two places that will lend to them, but it's going to cost them. And it seems weird that those places would be the ones to be condemned. Not all the companies that wouldn't even issue them a car. They get off scot-free. It's the ones who give them a card but has tough terms that are to be condemned. It just seems upside down.

**ZYWICKI:** That's right. And there's two points there, and those are really important points, Tom. The first is, as an economist, the first thing you would ask is if there's some sort of market failure here. And whether you look at credit cards or especially payday loans – payday loans are an unbelievably competitive business. Credit cards, as well. And the first thing you look for is basically, well, what are the operating costs. And this is one thing that Sanders and AOC don't understand, is the operating costs on credit cards are very high.

So what they talk about is this spread between the cost of funds and the interest rate. But it turns out, for a mortgage, the cost of funds, the underlying cost of money is something like 90% of the cost of the mortgage. You basically get it once, and then you more or less just pay it. For auto loans, it's like 75%. For credit cards, it's only about 30 or 40%, because credit cards are very expensive operations for a bank. You've got customer service; you've got processing a lot of small transactions; you've got dealing with merchants; you've got all these different – you've got billing costs every month; you've got dispute resolution, all these sorts of things.

And so what we've seen through history is that, whether underlying interest rates go up or down, credit card interest rates are less responsive to the cost of funds than other types of loans. And because we've been in a low-interest rate environment for so long, we don't appreciate the fact that even in the '70s, credit card rates did not rise as much proportionally as mortgages did, for example, where basically the cost was passed right through. And so when you take the cost and you take the risk, nobody's ever been able to find that credit card issuers or payday lenders or any of these guys have been making undue profits on these products.

**WOODS:** It reminds me of a piece I wrote a long time ago about rent-to-own stores, because they get the same kinds of criticisms. Because look, if I just went out and bought that couch, it would only cost me X, but these people are making weekly payments that add up to Y. Yeah, if they had the money to go out and buy it for X, they would, but it's precisely because they don't that people are giving them this opportunity.

**ZYWICKI:** Rent-to-own, it's a great example, Tom, which, almost all these things, you could trace back to the folly of experiments of the past. What really gave a boost of the rent-to-own industry were a bunch of judicial decisions in the 1960s that were designed to protect, in their view, consumers from furniture sellers, who were selling furniture on credit to consumers and they had what were called cross-collateralization clauses, where you basically could repossess all the borrowed furniture that they bought from you if they missed any of the payments. So once they told lenders, you can't sell the products to consumers on credit because they weren't going to sell it if they couldn't repossess it for nonpayment because these are high-risk borrowers, all they did was redesign it as a lease. And rent-to-own then came about as a way for consumers to be able to get household furnishings that they couldn't get because the regulators – in this case, courts – had taken away their direct option to be

able to purchase this stuff and own it. And so they had to redesign it as a lease, which then wasn't governed by all these usury regulations and other sorts of our rules.

**WOODS:** Oh my gosh, I wish I had known that when I wrote my piece, because it just goes to show: now they're complaining about the attempt to once again provide a service to people that was foreclosed because of the first dumb intervention they made, so the private sector is doing its best to cater to these people. They're upset that it's not the very thing that is foreclosed from their first – it's crazy. But then also, I got emails from a couple of people who were managers of rent-to-own stores, and they said, look, I know that obviously, yeah, if you add up the weekly or monthly payments, of course, it's going to be more than the retail price of the item. He said, but you have no idea how much of our time was spent chasing after deadbeats who wouldn't pay. It's unbelievable. The fact that we would at least get these people furniture at all is a miracle.

**ZYWICKI:** Yeah, and these are really highly labor-intensive businesses, whether it's this or the old, traditional installment lenders, who would finance a refrigerator or whatever. It takes a lot of phone calls. And this is a naïveté of the sort of the modern worldview of the Elizabeth Warrens and the Bernie Sanders and the like, is that they've got this worldview that the only reason consumers don't pay their debts is because they can't, that they don't have enough money, and the solution is to not have lenders lend them any more money. Well, number one, they need the money. But number two, what we also know is that – but that's not the only reason people don't pay them. And we saw it during the housing crisis, that what caused the housing crisis to get so bad was, yeah, sure, some people entered into loans that they couldn't pay. But a lot of people just decided to walk away from their house because it was underwater, and they just sort of rationally defaulted because their house wasn't worth what they were going to have to pay for it. And so they have this sort of naive idea that if you just make the loans affordable, people are always going to pay them, when in fact, that may be the case for some people, but for a lot of people, it's exactly this: it's chasing after people who either sometimes can't pay, but sometimes don't want to pay for what they borrowed.

**WOODS:** You were discussing some of this material with our friend Gene Epstein the other day, and he tells me that you talked about the possibility, if it were possible, of Walmart entering the consumer credit arena, and what that could mean for what the market would look like. First of all, what is stopping a Walmart from entering the same way they did with prescription drugs, where they came and they said, we'll give you \$4 generics? What's to stop them from offering lower interest credit cards? Is there anything stopping them?

**ZYWICKI:** There is, actually, which is the big banks, which is, about ten years ago, Walmart filed a petition to try to become certified as an actual bank, which would have allowed them to offer bank accounts, to offer credit cards, and the like. And basically, what happened was the big banks and the federal regulators through the Federal Reserve and the control of the current currency, blocked Walmart from doing that. What we have seen is that Walmart has entered other aspects of the personal finance space. So for example, check cashing I think is 88 cents to cash a check at Walmart, or 88 cents I think for a money order, maybe \$3 to cash a check. Walmart has been able to provide some of these financial services, but not the full suite, because they haven't been able to get recognized as a full-blown bank. And that's all basically because of rent-seeking and public interest pressure by the incumbent banks that fear Walmart. And you can imagine others. Amazon – I mean, you can imagine a lot of these companies providing a full suite of banking services that, right now, they're basically forced to partner with a bank to be able to provide.

**WOODS:** Now, Amazon I think does offer a credit card, but even there, they're hemmed in by some restrictions.

**ZYWICKI:** Yeah, that's right, and it's co-branded with — a general purpose credit card they have to offer through, I think Chase is the one that that does it. So basically what it is, is it's a Chase credit card that provides special things on Amazon, but it's not like a direct product that they could potentially offer. And I think one of the things that's equally goofy about the Sanders-AOC proposal is this idea they have for post office banking, which is — it's not quite clear what it what it would be. Their legislation is only three and a half, four pages long, and they don't talk about it. But Walmart's already doing that. Walmart is already doing 88 cents money orders and \$3 check cashing, right? And it's not quite clear why they think that post office banking is going to be a panacea, and I don't think anybody seriously thinks that the post office is going to be able to get into the business of making small-dollar loans like payday loans and that sort of thing, and as you said, go through what all it would take to try to collect those loans and all those sorts of things.

**WOODS:** Can you tell us something about the Consumer Financial Protection Bureau, founded in 2011 to protect consumers in the area of credit?

**ZYWICKI:** Sure, I could tell you a lot about it. And this is one of the things that I find very frustrating about this whole debate, is in the wake of the financial crisis, during the Obama administration, they unleashed such a slew of regulations starting with what was called the Credit Card Act of 2009, and then we had the Dodd-Frank legislation. A key provision of the Dodd-Frank legislation was a provision called the Durbin Amendment, which placed price controls on debit card interchange fees. What the effect of all of this was — and it also included the Consumer Financial Protection Bureau, of course. And when you put the CFPB's regulations and enforcement together with all this other regulation, what we saw during the Obama administration was a huge amount of regulation that ended up impacting lower income households and people on the margin the most.

So a good example was the Durbin Amendment. The Durbin Amendment — interchange fees are the fee that gets paid by the merchant whenever you swipe your card at, say, Target or 7-Eleven. And they cut those fees in half. Those fees had basically been the vehicle for free checking to spread in the economy. And so what we saw in the years following that is free checking was cut in half from about 76% to 38% of bank accounts. Those who had to pay a monthly fee saw their monthly fees double. And who got impacted the most by that were low-income Americans, right, who lost access to free checking, bank accounts became very expensive. And what do we see? Probably as many as a million low-income consumers lost bank accounts because they couldn't afford them anymore. And so what we ended up seeing was this series of things that caused low-income consumers lose credit cards, to lose bank accounts. What that does, as we were alluding to earlier, is push people out of those mainstream products into things like payday loans.

And of course, the swan song for the CFPB director, Richard Cordray, when he left to go run for governor of Ohio was, of course, to essentially wipe out the payday loan industry, which had basically become the life raft for a lot of Americans who had lost access to other products precisely because of regulatory overreach. And fortunately, the new director of the CFPB has announced a plan to roll back the payday loan rule and allow payday loans to continue to be offered to consumers. But that kind of shows the mentality, which is more and

more regulation that fell hardest and hurt low-income Americans the most, and their response was basically to take away more choices and make life even more difficult for them.

**WOODS:** The website, or if I go to [ObamaWhiteHouse.archives.gov](http://ObamaWhiteHouse.archives.gov), I get a big song and dance about why we need the Consumer Financial Protection Bureau. But one of the things they'll say is that, *Look, we had to learn the lessons of 2008. We had mortgages being sold to people who couldn't afford them or sometimes even understand them, so you have opaque financial products being passed off onto consumers, and it leads to bad consequences. We need clarity. We need to shine a light on this.* And that sounds superficially plausible to a lot of people. So what's wrong with it?

**ZYWICKI:** Well, I actually didn't have that much of a problem with the idea of a consumer protection agency. I worked at the Federal Trade Commission when Tim Muris was chairman, and the idea of something that – basically, the regulatory system before the CFPB was very decentralized. It basically had a whole bunch of agencies with different agendas and the like. The problem is not so much I think the idea – I would not have created a new agency; I would have just given it all to the Federal Trade Commission, personally. The problem was the way it was executed, and it was executed in his way of basically – what they claimed that they were going to do was basically make it easier for consumers to find the products they wanted. And essentially what they did beginning from day one, is essentially bring back 1970s Naderism and 1960s-style consumer activism, and it had the same consequences that we had that we were talking about earlier.

The only difference this time around is it seems – and this is what I find very disconcerting about something like the Sanders and Ocasio-Cortez thing and the idea of comparing to loan sharks and the like is, in the past what is – as I said, this has been cyclical. We've had interest rate ceilings, but eventually after a generation or so, they get repealed because they end up hurting people so much. So for example, in 1968 during the so-called good old days, a United States Senate report found in 1968 that loan sharking was the second largest revenue source of the mafia. It was estimated to be at that point about a \$10-billion-a-year industry nationwide, which is about \$70 billion in today's dollars, was what they estimated the size of loan sharking was. That's twice the size of the payday loan industry in America today. And we had real people getting hurt. When Anthony "Fat Tony" Salerno, the head of the Genovese crime family, was indicted in 1973 on 14 counts of loan sharking and, in fact, one leg of criminal solicitation to have a victim's legs broken, he was running \$80 million a day on the streets of New York just in his territory, which is a little less than half a billion dollars in today's money.

And so what we saw was liberals, the consumer activists, the consumer protection people said, you know, maybe it's better to allow consumers to pursue products and choose the products they want in competitive markets, rather than pretending like they can go without credit and forcing them into the arms of the loan sharks. And in fact, of all people, Robert Kennedy – when Bobby Kennedy in 1964, when he was elected to the United States Senate from New York, the New York State Legislature held hearings that year on organized crime in New York. And Robert Kennedy sent a letter to the New York State Legislature and said, the first thing you should do is reconsider our state usury ceilings and put usury ceilings that are a reasonable level so that consumers can actually get access to credit and not have to go to the loan sharks.

Today, we just seem to live in a world of wishful thinking, where, rather than recognizing reality, we get proposals like this one, where we basically have Senator Sanders and Representative Ocasio-Cortez just pretending like the guys who work on Wall Street today are the same as Fat Tony Salerno and the like, and that somehow or another, we're going to make people's lives better by taking away their choices.

**WOODS:** As we wrap up, you have a book that you put together with several other people called *Consumer Credit and the American Economy*. Does any of that deal with – because I haven't had an opportunity to look at it – the development of some of the laws and regulations, to the point where it tells us not the textbook version of, *These regulations were established by public-spirited representatives for your own good*, but rather kind of gives us more of a realistic picture of what happened?

**ZYWICKI:** Absolutely. It's a big, thick book. It's not a book for popular reading. For those who are interested in some of the background on this, I published about 15 years ago an article called "The Economics of Credit Cards," where I go over some of this history. But you're right. I mean, one of the things that we've seen is that a lot of these laws are explained by public choice and they're explained by interest group pressures. As we were talking earlier, for example, one of the biggest obstacles today of getting financial products to lower-income consumers is the fact that banks have blocked companies like Walmart from being able to get fully into the business of banking. And that's a longstanding story. So the book goes through that in some detail.

One of the things that's interesting that we see that people don't understand, as we close talking about credit cards, is the real great growth of consumer credit in America was in the postwar era, which is, when that whole migration to the suburbs – basically, you know, when people left the cities and moved to Levittown, that was all fueled by consumer credit. They needed a car, the three-bedroom house with furniture and modern appliances. People weren't paying for that on cash. People were paying for that on credit. And the credit they were using was credit from department stores, it was credit from appliance shops, and things like that. And all credit cards have really done is created a more competitive market and increase consumer choice, and it's actually driven down prices compared to what those old creditors used to do. And so it's a fascinating story of credit as interwoven in the history of 20th century America. And this story of the cycles of regulation and deregulation is a hugely important part of that story.

**WOODS:** Well, I'm going to link to that article; I found it, your article, "The Economics of Credit Cards." I'll link to that on the show notes page, along with the book, and the page is [TomWoods.com/1415](http://TomWoods.com/1415). And I'll also link to your Twitter and your faculty page at the law school. Well, I appreciate your time very much. This is interesting material. I didn't know exactly who the right person was, and then it just so happened, good old Gene Epstein – boy, he has bailed me out of many a jam [laughing] – came along. And I'm glad we had a chance to speak. Thanks so much.

**ZYWICKI:** Thank you, Tom.