House of Commons
CANADA

Standing Committee on Finance

FINA • NUMBER 034 • 2nd SESSION • 40th PARLIAMENT

EVIDENCE

Tuesday, June 9, 2009

Chairs

Mr. James Rajotte
The Honourable Michael Chong

Also available on the Parliament of Canada Web Site at the following address:

http://www.parl.gc.ca

Standing Committee on Finance

Tuesday, June 9, 2009

● (0900)

[*English*]

The Co-Chair (Hon. Michael Chong (Wellington—Halton Hills, CPC)): I welcome our members and our witnesses to the joint meeting of the Standing Committee on Finance and the Standing Committee on Industry, Science and Technology this Tuesday, June 9, 2009. Pursuant to Standing Order 108(2), we are studying the credit card interchange system and the debit payment system in Canada.

Before us today we have four witnesses. Mr. Ian Lee is director of the MBA program in the Sprott School of Business at Carleton University. Mr. Barry Scholnick is associate professor in the School of Business at the University of Alberta. Mr. Roger Ware is a professor in the Department of Economics at Queen's University. Mr. Jack Carr is a professor in the Department of Economics at the University of Toronto.

Welcome to all four of you.

Mr. Menzies, go ahead.

Mr. Ted Menzies (Macleod, CPC): On a point of order, I don't mean to delay proceedings here, but we have a housekeeping issue. The finance committee has invited the finance minister to come specifically to that committee. Because he's travelling on the day we had asked him to come, he's only able to come on the morning of June 16. I beg your indulgence to convene the finance committee on the morning of June 16 from 9 o'clock to 10 o'clock to hear the Minister of Finance.

Perhaps we could reschedule the next meeting of the joint committee until later.

The Co-Chair (Hon. Michael Chong): I believe discussions have been had with the various parties involved and members are amenable to that. We'll get the clerks of the two respective committees to reschedule our meeting of next Tuesday.

Mr. Ted Menzies: Thank you.

The Co-Chair (Hon. Michael Chong): Without further ado, we'll begin with opening statements from our four witnesses, beginning with Mr. Carr.

Professor Jack Carr (Professor, Department of Economics, University of Toronto, As an Individual): Thank you very much. I thank the committee for inviting me here today. I should tell you, and I'm sure it exists with my colleagues, that professors are used to speaking in fifty-minute segments, not five. So it's going to be a little difficult.

I have a paper that should be handed out. The things I leave out are in the paper. It's not a long paper. And I should also tell you that my research has primarily been financed by Visa.

Let me get to it, given the time I have. The key feature of the credit card system is that it's a two-sided market, and a two-sided market is somewhat different from the markets economists generally deal with. A two-sided market is a market where there's an interrelationship between the two sides, and in the credit card business the two sides are the merchants and the cardholders. You can't run the system without cardholders. You can't run the system without merchants. The more cardholders there are, the better it is for merchants. The more merchants there are, the better it is for cardholders. It's like a network and there are these interdependents on both sides.

Cardholder demand for system services depends on other things: the level of cardholder fees, the value the cardholder places on the convenience of using the cards over other means of payments, and the number and quality of merchants participating in the system. Essentially merchants' demand is very similar. They depend on merchants' fees, the efficiency of accepting cards over other means of payments, and on the number and quality of cardholders.

The point I want to emphasize from the beginning is that this two-sided nature of the market makes the economics somewhat different from what it normally is.

There are three important points about the payment system. First, it's important to remember that the issuing and acquiring identities are through the payment system organization jointly engaged in the production and supply of services. It's joint production. Second, it's important to understand the two-sided nature of this market.

Evans and Schmalensee give a real-world example. In Asia, particularly, there are dating clubs, and in dating clubs men and women can go and meet one another and see if they are suiting each other's needs. It seems to be that men value these clubs more than women, and what generally happens in these clubs.... It's just as costly for the owner of the club to service the women and the men in the club, and to bring them in, but it's generally the case that women are not charged; they're even given free drinks sometimes, and men pay all the costs. Seems fair. And it's done to operate an efficient system. It's done because men won't come if there are no women. Women won't come if there are no men. You have to balance the system, and the way you balance the system is through an interchange fee. You have men pay this fee, not related at all to cost.

The third economically important feature of two-sided markets is that both sides of the market benefit from the growth and demand of the other side. Recently there have been challenges to four-party systems, particularly in Australia and a number of other countries, and in this country too. There are two important points to understand. First, people who criticize the system argue that merchants should not be required to cover any of the costs borne by the issuers who are providing the services to cardholders, since retailers argue they don't receive any benefits from them. It's claimed that a collectively set interchange fee imposes such costs on merchants. Accordingly, retailers urge that the interchange fee should be calculated on the basis of an objective cost standard, which excludes costs not related to payment networks. Second, it's argued that rules such as honour all card rules and no surcharge rules effectively force retailers to accept Visa and MasterCard.

● (0905)

I'm going to argue that there are flaws in these arguments, and particularly I argue there are about five flaws.

The first flaw is that merchants do receive benefits from payment card systems. They get increased sales and increased convenience. Increased merchant sales rise because when people use credit cards to make purchases, and larger purchases, they bring in new types of purchases, and you get increased sales because there are lower transaction costs. When I go and fill up my car with gas, they don't need as many employees because I pay myself. I put my card into the machine. If everybody paid cash, you would have huge lineups. Also, the merchants don't have to hold cash balances, which generally are costly.

The second flaw is there's no economic justification for cost-based regulation. You don't want to just look at cost. Cost is one factor, but it's not the only factor. It's a more complex system, and by limiting the justification of interchange fees only to cost, the argument fails to account for the respective benefits that merchants and cardholders derive from interchange fees.

The third flaw is that retailers are not forced to accept credit cards as payment methods. They do so because there are benefits. It's less costly for them to use it, when you measure all costs. And merchants can refuse to accept them. There's a large number that do. Costco, a huge merchant, doesn't accept MasterCard and doesn't accept Visa. My wife and I both love Costco.

Four, there's another flaw. There is no subsidization of credit card users by cash users. There's this argument that people who use cash are subsidizing credit card users. Yes, there is a no-surcharge rule, but there's no rule prohibiting merchants from giving a discount for cash. There's no difference, from an economic point of view, between surcharging for credit cards or discounting for cash. Merchants do discount for cash, but it's very rare. A lot of times, I would argue, they do discount for cash in order to avoid paying all sorts of taxes. Cash is a method to get around paying taxes.

Flaw number five is that there's no rational economic basis to distinguish between three- and four-party systems. There's no difference to distinguish between the Amex system and Visa and MasterCard.

Let me conclude with the lessons from Australia, and let me read you a quote from a study by Robert Stillman et al. They concluded that:

> Regulations should only be employed if there is clear evidence of a market failure and only if there is reason to believe that regulation is likely to benefit consumers.

The RBA's regulations have clearly harmed consumers in Australia by causing higher cardholder fees and less valuable reward programs and by reducing the incentives of issuers of four-party cards to invest and innovate. At the same time, there is no evidence that these losses to consumers have been offset by reduction in retail prices or improvements in the quality of retail service.

The empirical evidence does not support the view that consumers have derived any net benefits from the intervention. Generally, economists think of regulating an industry where there's some monopoly power and there's too little output produced and too high a price is charged. Regulation in Australia and regulating interchange fees causes a reduction in output and a higher price to consumers—it goes against what economists generally believe are the necessary conditions for regulation.

Let me conclude. Before analyzing two-sided markets such as the payment system industry, it's critically important to understand the unique economic considerations that drive this efficiency and its competitiveness. Foremost among these is the interdependence of demand among the acquiring and issuing sides. One must consider the cost and benefits provided to both sides of the market rather than focusing on one aspect of the market in isolation.

Thank you very much.

● (0910)

The Co-Chair (Hon. Michael Chong): Thank you very much, Mr. Carr.

I believe Mr. Scholnick has a PowerPoint presentation.

Professor Barry Scholnick (Associate Professor, School of Business, University of Alberta, As an Individual): Thank you for having me.

I'm a professor at the University of Alberta. I should emphasize that I have no relationship with any of the various parties that have come before you in the last couple of weeks.

My role this morning is to give you some sense of what economists talk about when they think about this market. This is a very complicated market; it's very different from our standard textbook market. So maybe economists can give you some help in deciding how to approach the problem you have.

I think the key point, as my colleague has mentioned, is the notion of a two-sided market. This dominates economic thinking, and this is the key concept the committee should understand before deciding how to proceed. The idea of a two-sided market is the notion that you have a single platform—and this is the key word, “platform”—that brings together many buyers and many sellers.

What does this mean? What I've done on this slide is try to give you some examples—and there are countless examples—of platforms and how the economics work. The first example of a platform is precisely what you're discussing in these hearings. Visa and MasterCard provide a platform where they bring together lots of people on one side of the market, the retailers, and lots of people on the other side of the market, the consumers. By bringing these two sides together, they create some value. That's the value of their platform.

But there are many other examples, which I've shown you on this slide. For example, for real estate listings, real estate boards have websites all over the country. These websites bring together house buyers and house sellers. But the platform in the middle is the real estate board, and that's the key economic actor we care about.

Another example is shopping malls. A shopping mall can be thought of economically as a platform. What does it do? The owner of the shopping mall brings together two sides—side one, the store owners, and side two, the shoppers. So the shopping mall in itself doesn't do anything or sell anything, but it brings these parties together.

Other examples are the Yellow Pages and PDF files. A PDF file is a platform with readers and writers. And Google can be thought of as a platform; you have Google advertisers and Google searchers. One point to emphasize with these platforms is how their services are priced. How do Google or the Yellow Pages price their services? What you find very commonly with all of these platforms is that one side is highly subsidized—in many cases it's free—and the other side pays. So in the examples I've shown you, when you search on Google, for instance, it costs you nothing. But when you advertise on Google, when you're a seller, it costs you a significant amount of money. And for PDF readers, when you read a PDF document from Adobe, it's free. But if you want to write one of these things, it costs you a lot of money. Similarly with the Yellow Pages; on the one side the readers get it for free, etc.

So what you have as a standard outcome in the economics literature with the pricing of these platforms is that one side bears the costs and one side gets it for free. In fact, I would argue that in the credit card case, not only do the consumers get it for free, but they also actually get rewarded or more money when they use their credit cards. That, of course, is the notion of rewards—air miles and cash back, etc. This fits in very much with standard economic thinking about how these two-sided markets should work.

So what are the implications of these two-sided markets? The key point to emphasize, I believe, is the notion of winner takes all, or what we call “network effects” in economic jargon. What this means is that if you have a platform that everybody loves, if you have a platform that both the buyer side and the seller side use extensively, then you have a very valuable asset.

The second part of the winner-takes-all story is that once you get big, you get even bigger. So the big get bigger. There are built-in economies of scale, the way economists describe this. That, of course, is the situation that Visa and MasterCard find themselves in —and that is the situation every platform owner wants to be in. Another example is Microsoft as a platform. It's so big, everybody uses it. Nobody has a choice not to use it.

● (0915)

The key objective of the people who own the platform, whether it's Microsoft, Google, Visa, MasterCard, Yellow Pages, or whatever, is to get as much money as possible, like every business owner. But at the same time they have to balance and make sure they have enough on the buy side and enough on the sales side to keep the thing going. As soon as you have a situation where either one of these parties leaves the platform and goes somewhere else, the value of the platform gets less and eventually becomes zero. So they have to get as much money as they can, while at the same time keeping everybody using them.

So you have a situation—and this is standard economics and how we understand these two-sided markets—where you find yourself like the retailers you've heard in your committee. If you find yourself in a situation like in the Visa or MasterCard case, where you have a very successful and dominant platform, you're essentially stuck. You can't get out because all your customers demand that you use the platform, and there's nothing you can really do to reduce your fees.

So what do they do? Standard economics literature on two-sided markets says they do precisely what's happening at this meeting this morning. They lobby Parliament and go to the courts, the central banks, and the competition authorities. The economics literature tells us it is not possible for these guys to use standard economic mechanisms to escape the trap in which they find themselves.

So how do we get out of this? What is the threat to Visa or MasterCard, or any of these two-sided markets? I could be talking about Microsoft or Google; it's the same argument. The threat they face is a new and better platform that does things to make more people happy—new technology. I've given you the example of PayPal and the slow emergence of a platform on the web that might one day overcome Visa and MasterCard as a payment provider. That's the thing: once this new platform comes into being, Visa and MasterCard face the problem.

What are the implications of these two-sided markets? What does economics literature tell us to expect? First, the fight you've had before you for the last couple of weeks between Visa and MasterCard on the one side and the retailers on the other side is very predictable. This always happens. This identical fight has been happening around the world. My argument is that this will continue. These meetings will certainly not be the last ones this House hears on this matter.

Even if a new dominant platform overtakes Visa or MasterCard, this kind of conflict between the retailers on the one hand and the platform on the other hand will carry on. Even if, for example, the Reserve Bank of Australia imposes some sort of regulation, this will not solve the problem. There is no nice, easy answer based on economics literature as to how to fix this problem, because of the nature of these two-sided markets.

Thank you.

● (0920)

The Co-Chair (Hon. Michael Chong): Thank you very much, Mr. Scholnick.

Mr. Lee, I understand you have a hand-out as well.

[*Translation*]

It is also in the other official language.

[*English*]

Professor Ian Lee (Director, Master of Business Administration (MBA) Program, Sprott School of Business, Carleton University, As an Individual): Thank you very much. As a former banker and a business school professor, I want to thank these two committees for inviting me. I clearly have a bias. I think you are the two most important committees in Parliament, finance and industry, because you're dealing with the most important issues of how we create wealth in our economy.

Just by way of background, I was in banking in the 1970s, in the bank right across the street, the Bank of Montreal, which I understand Parliament is now going to be using. It's a beautiful building. I hope you'll treat it well.

I was a consumer loan manager, a mortgage manager, a commercial loan officer, and I have a Ph.D. in public policy. Now I'm the MBA director in the Sprott School of Business. I do want to mention that I've taught over one hundred times in the Middle East, Asia, and Eastern Europe, including most of the former communist countries, where I saw, up close and personally, the impact of coercive government regulations in destroying the environment, the economy, and human rights.

Finally, I don't consult, advise, or invest in any firm, union, NGO, non-profit, government, or political party, so I come here with complete transparency.

I read all of the transcripts for the past two months in both your committee and the Senate committee. I really want to be somewhat provocative today and suggest that many of the witnesses—the Retail Council, CFIB—suggested that the payment system today in Canada is very expensive and inefficient, and I think this is really an urban myth.

Just to put some reality into the conversation, from time immemorial until the 1970s, even until the early 1980s, banks opened at 10 in the morning and closed at 3. If you couldn't get into the bank during that time, you didn't get your money. There were no debit cards, there was no Internet banking, there was no phone banking. Credit cards only emerged in the mid to late 1970s.

There were two payment systems: cash and cheque. Both were expensive, slow, and dangerous. Why were they so? Because cheques bounced regularly, every day. This was a very large risk to retailers. Cash was stolen in holdups or by workers. Although that risk wasn't so great, it drove every business person to invest large amounts of money to buy insurance, to bond employees, the due diligence, safes, costly cash custody, and so forth.

To endorse what Professor Carr and Professor Scholnick said, the transaction costs are very expensive. But today, debit cards provide instant payment, no recourse, no bad cheques, and the same thing with credit cards. So I'm arguing that the transaction costs are very cheap, at 0.5% to 4%.

This was borne out by a study by two think tanks very recently in Washington, D.C. The conservative American Enterprise Institute and the very liberal Brookings Institution did a study of payment types, and not surprisingly they found that cash was the most expensive form of payment. I heard some of the witnesses suggesting discounting for cash. If I was running a business, I would demand a premium for someone to pay cash because cash is very expensive. Bankers understand that. There are large hidden costs with cash. You have to have complex, elaborate accounting systems. You have to have, for example, two people counting the cash, if you don't want to get ripped off. By contrast, credit cards stimulate big-ticket purchases and stimulate impulse items.

I want to alert you to a study that was done only eight months ago by the Bank of Canada in this city. They did a large survey of businesses across Canada, and they had three findings in this survey of actual business people. They found that debit cards are preferred as least risky—I have no problem with that. Secondly, many businesses perceived that cash was the cheapest and most reliable. That is empirically false. Thirdly, the cards were seen as the most costly and least reliable. For the same reason that I argue the second finding is wrong, I argue this too is wrong. What this demonstrates is that a lot of small businesses are financially illiterate, or at least partially illiterate, and this points to the need for more literacy programs.

In fact, what happened over the past ten years? What was their actual behaviour? On both the consumer side and the commercial side, the use of credit and debit cards went up. In a study done by the Federal Reserve, I believe—I have the sources in my laptop—we're at the mid-point across some 10 or 15 countries in terms of the cost to the merchant for the use of cards.

So what is the problem? I'm arguing that the problem is the misperception of the cost of cash versus credit by business, producing, as my colleagues have suggested, rent-seeking by trade associations coming to Parliament and trying to get you to give them more profits instead of earning it the traditional way, through competition.

This is from the Federal Reserve, showing the profitability of credit cards, and you'll simply note that it's cyclical. It's on the screen. It is cyclical based on two variables: the cost of money and of course the credit losses.

● (0925)

What we're experiencing in Canada right now—this is from the DBRS, the bond rating agency—is that credit losses are soaring. As you can see, the red line, which is the weighted average, is pushing up to 6% for all credit card balances that are going to be charged off to bad debt in 2009. That is a horrific charge-off.

When I was a mortgage manager I had a zero charge-off, and on personal loans we had between a quarter to a half of one per cent. They're up to 6%, which is just off the charts.

Again, you can see this on the next one, the delinquency on loan losses in Canada is up to 35%, and the loan loss rate on credit cards is up to 44%.

I won't belabour the Australian solution. We already know it. You know it from the people who have testified. But I do have a couple of graphs you'll want to look at. These are from the Federal Reserve, which did a study. I believe Professor Carr quoted that study. After, I think it was four years, there was no change in the relative share of credit card use or debit card use. However, what did happen is that merchant fees went down and the banks recouped a very large amount through increased card fees.

You can see the two lines. The green line going up is the card fees charged on standard credit cards and the red line is the fees on the premium credit cards. What the Australians did was they simply shifted the burden from the merchants to the consumers. So what the Retail Council and the CFIB are asking you to do is to not stick it to them; they want you to stick it to the consumer, who is me.

The bank issuers, as this slide shows, recovered 30% to 40%, or a half billion dollars, from consumers. The irony is that the merchant costs fell on a transaction basis. When you run through the numbers, they dropped about four cents on a $40 purchase, which is really quite trivial. So there were no dramatic changes.

I won't summarize, because Professor Carr already dealt with this. The same Federal Reserve economist that Professor Carr spoke about reported that the regulations of the central bank, the Reserve Bank of Australia, failed to achieve their policy goals.

So what are the alternatives? I'll just wrap up.

I make three assumptions. One is that you, the legislators, face a choice of governing instruments from the least coercive, such as required information disclosure, to the most coercive, such as government ownership or the price controls advocated by the Retail Council or the CFIB. My second assumption is that you should select coercive instruments only when all else has failed, when there's clear evidence of market failure, and there is no evidence of market failure in the card systems.

My recommended policy solutions include much more rigorous information disclosure concerning rates, fees, benefits, costs, and interest charges; secondly, enhanced regulatory oversight to address deceitful or anti-competitive practices; and thirdly, financial literacy in the schools, in the education system. And I mention that because some witnesses expressed deep skepticism about literacy programs, but we do in Canada spend billions on primary school education, secondary, and post-secondary, so it would be a bit disingenuous for a professor to advocate against literacy programs.

Thank you.

● (0930)

The Co-Chair (Hon. Michael Chong): Thank you, Mr. Lee.

Mr. Ware.

Professor Roger Ware (Professor, Department of Economics, Queen's University, As an Individual): Thank you, Mr. Chair.

Can I just clarify something?

I had prepared some of my remarks on debit cards. My understanding, and perhaps it's incorrect, was that this was going to be part of the discussion.

The Co-Chair (Hon. Michael Chong): It is. That's correct. The study is on both the credit card and debit card systems.

Prof. Roger Ware: Thank you. Then I'll include those.

I'm a professor of economics at Queen's University, and I have had an interest in payment cards for quite a long time now, certainly dating back to when I was involved in the Interac hearing in the mid-nineties, which led to the creation of the current debit card system in Canada.

I'm going to begin by talking about interchange fees, as my three colleagues have, but I don't think you need to hear anything more about two-sided markets. Interchange fees, though, are set to balance the incentives of merchants to accept the card with the incentives of the issuer to issue it and the card holder to use it. The interchange fee, in effect, is paid from the merchant—strictly speaking, it's paid from the acquirer—to the card issuer and is not a conventional price.

This is a point, although my colleagues have been over this ground a little bit.... We think of high interchange fees as hurting merchants, because it's a price, and high prices hurt the people who have to pay them. But of course because it's a two-sided price, it's really not that simple. As I said, the interchange fee is designed to balance these networks, which have a joint interest in maximizing the acceptance by merchants, and of course merchants, who have an interest in large numbers of cards being available—as do card holders, so that when they go to buy a shirt they can find a merchant who will accept their card.

There are some theoretical conditions under which the interchange fee is completely neutral, in fact. Changes in the fee are balanced by changes in surcharges and in card fees, so that all parties are indifferent as to the actual level of the fee. Most academic economists who have studied this don't believe that we necessarily have that theoretical situation. The problem, though, in my opinion, is that we do not know enough yet about how the state of competition in acquiring and issuing really interacts to determine what that interchange fee is in the absence of regulation—in other words, from an economic welfare point of view.

You've heard quite a bit, both from my colleagues here and earlier I think about the Australian experiment. As we know, and we just saw some data on this, one thing we do know about it is that the reduction in interchange fees through regulation in Australia led to an increase in card fees and to a reduction in value of rewards to card holders.

There is a subtle and important question, which Jack Carr hinted at. That is, do the various prices and fees in these payment networks distort the pattern of payments? That is, if we think about credit cards, debit cards, and cash—and again my colleagues have talked about this—is there a tendency for, let's say, a higher percentage of payments to be made via credit cards relative to some kind of social optimum? It's an interesting question, and there are some academic discussions of this. My view is that we just don't know the answer yet. I would agree with my colleagues very much that in a case in which we don't know the answer, it's too soon to rush into regulation. Regulation is desirable when we have a clearly identified market failure and understand in which direction our intervention is going to improve things.

There is an important question on which Canada's situation is a little different from that of other countries, and that is the question of whether the credit card network is acting solely as a joint venture of the member banks or whether it's acting as an independent corporation in its own right in order to pursue its own profits. In Canada, as you know, the credit card networks have recently restructured themselves in order to be the latter, partly as a result of prompting from the Competition Bureau, which wanted that change in order to approve the duality—the change to allowing banks to offer both card networks, or to issue cards from both MasterCard and Visa.

● (0935)

Again, in the academic studies, one of the things that's likely to influence interchange fees is whether or not there's more imperfect competition at the issuing end or more imperfect competition at the acquiring end. There have been some studies suggesting that it's likely to be more at the issuing end, and the reason for that lies in the idea of switching cost. For the consumers who hold those cards, it can be difficult to change one card to another card, because first of all, you quite likely have a balance on it, and second, you have a bunch of card numbers in your online shopping networks—if you're me, you have, anyway. So consumers face some switching costs.

But again, I would say we do not know the answer to this. This is an interesting academic question, but we don't know the answer from the policy point of view.

Another question, which again my colleagues touched on, concerns “no surcharging” rules. There are some international differences here that are interesting. For example, in the U.K., where these issues have been studied quite a lot, the no-surcharging rule was abolished in the early 1990s, and yet there has been very little surcharging. As my colleague here pointed out, there's also very little cash discounting.

However, in Australia—at least, my understanding is—since they abolished their no-surcharging law, which was just about five years ago, I think in 2003, there has actually been quite a lot of surcharging. The number I saw is that 23% of credit card transactions through what are called large retailers are now surcharged, if you use a credit card. That's a pretty big number. I throw that out there to say that this is something that is interesting and possibly important, and we don't know a lot about it.

In conclusion on credit cards, just to restate what I've said earlier, I think it's much too early for us to have a definitive conclusion about any form of regulatory intervention in this market. I don't think we understand it well enough. We have the Australian example, and it's not at all clear that it was a success. It's possible there will be some intervention in the U.K. soon, and we may learn something from that.

Let me make just a few remarks on debit cards, if I may. We've had an unusual situation in Canada whereby we've had a single debit card network now for more than ten years—the Interac network. It's been regulated so that it's a not-for-profit organization. The question is, which system is preferable, a regulated natural monopoly, if it is a natural monopoly, or a competitive system in which merchants and consumers choose the debit network they want to use for each transaction? Ideally, a merchant could choose to subscribe to one or more debit card networks, and a buyer might have the choice, for any given transaction, to route it through network A, which might be Interac, or network B, which might be the new Visa debit network that is going to be rolled out, I believe, sometime in the near future.

Natural monopolies have the property that because of network economies and scale economies, a single supplier is the most cost-effective organization within which to supply the market. However, this conclusion is essentially a static one and ignores all the dynamic economies and incentives for innovation that come from a competitive system in which networks compete.

The policy concerns with debit cards mostly have to do with merchant fees, and to some extent with interchange fees. Interchange fees in the Interac debit network are currently set at zero. The concern I've heard is that when Visa debit enters, and possibly MasterCard debit as well, the cost to the merchant will go up.

● (0940)

One of the ways this has been expressed is through the concern that the current fee to a merchant for using an Interac debit card is about 12¢. It's a flat per-unit fee. When Visa debit comes, in I believe they're going to be using a more complicated fee structure, which is partly value based. It's partly a percentage of the value of the transaction.

To just finish up, my view of this is that competition is good. We have to start from where we are. Where we are is we have a monopoly. We should not be throwing up our hands and expressing alarm that we're going to get entry here. Entry is a good thing; entry is going to create competition. It's most likely that entry will create benefits for consumers, because that's what entry does. The concern has been expressed that somehow Visa debit will become a dominant firm in the debit market. It seems to me to be very premature. At the moment, Interac is, of course, the dominant firm.

Thank you.

The Co-Chair (Hon. Michael Chong): Thank you, Mr. Ware.

Thank you to all of our four witnesses for their opening comments. We're now going to go to comments and questions from members of this committee for the next hour and a half.

[*Translation*]

We speak both official languages here. Members will be asking questions in both French and in English.

[*English*]

If you require translation, there are earpieces provided. The channels are listed on your desk.

We'll begin with Mr. McCallum.

Hon. John McCallum (Markham—Unionville, Lib.): Thank you, Mr. Chair. Thank you to all four economists for being with us today.

Jack Carr began by saying that professors talk in fifty-minute sound bites. I used to, but now I have seven minutes, maximum, including your answers to questions. I shall try to be succinct.

The first question is that the two-sided market idea is appealing, but I wonder in the case of credit markets, given that banks are such key players as issuers, whether that's not a little oversimplified, and that in some ways there must be three sides. This is perhaps to Professor Scholnick.

Prof. Barry Scholnick: That's absolutely true. In fact, in economic literature they talk about many-sided markets. It doesn't have to be two. Two is just a simplification. Clearly, you would have in this situation multiple sides. As a simplification, the way I think of this game is between buyers and sellers. I would put together the banks, Visa, and MasterCard on the same side, as part of the platform. That's the key part. They are the middle people who try to bring together lots of buyers, who are consumers, and lots of sellers, who are retailers.

The way I envisage the issue before you is to think about retailers, who are the sellers, and consumers, who are the buyers, and the platform. For me, that's the key word when I'm trying to think about this issue. How does the platform work? Whether or not there are multiple parties within the platform, I think that's quite obvious in this case. It's quite possible to have multiple-sided markets.

Hon. John McCallum: Thank you.

One of my colleagues suggested at some earlier meeting that we all want more competition. There are only two major card companies, Visa and MasterCard, and there are at least six banks or more. Would it make sense or would it be technically feasible for the interchange rates to be set by the banks rather than the credit card companies? That would seem to lead to potentially more competition, but it possibly wouldn't work. This is why I'm asking the question.

Maybe we'll go to Professor Ware on that one.

Prof. Roger Ware: As I said earlier, there is this key question. First of all, it is whether the credit card network is structured as a joint venture of the banks or whether it's an independent corporation. Let's assume, first of all, that it's the latter, which is true in Canada at the moment. In a sense, it is the credit card network that is representing the interest of the network. The banks, of course, are acting in their own interest. The banks have the interest of one side of that network, the issuing side, if you like.

It's the network that's interested in balancing the acceptance by merchants with the issuing of cards and the use of cards by cardholders. I would say giving the banks the right to set the interchange fee is sort of biasing the network in the direction of one side of it. It's not quite clear to me as a regulatory initiative exactly how one would do that.

● (0945)

Hon. John McCallum: Do any of the other three disagree with that view? If not, I'll go on to another question. Okay.

This one, also for Professor Ware, is on the subject of Interac. My impression is that Interac has served Canadians well, at low cost, for a good number of years. I'm not opposed to new competition from MasterCard or Visa necessarily. But a lot of people think that international experience suggests that once they get in there, they will tend to raise rates, and consumers or merchants will end up paying more than they do at the present time. One of the problems is that Interac has been structured in a way that its governance model is not appropriate for dealing with the new competition. Interac, in a sense, is like the David, in my view, fighting these two new Goliaths. Maybe there's a role for government or Parliament to try to improve the situation for Interac so that it can better compete with these two new major global forces. Would you agree with that?

Prof. Roger Ware: Yes, actually, I do agree with that.

Hon. John McCallum: Ah, the first one I've hit.

Voices: Oh, oh!

Prof. Roger Ware: Just to go back to the beginning of your question, absolutely, Interac has been a huge success. As you know, I'm sure, I think we're the second biggest debit card users in the world, right after Norway, I think. It's been a huge success, yes. Part of that is because of the standardization, the simplicity, and the openness that was created by the consent order from the Competition Tribunal in 1995 that allowed anyone to connect, basically. That's the first point.

The second point is whether the governance structure of Interac is serving it well now. The answer is no, it's not. If it's going to compete, and I certainly would support competition—we want competition—it needs to be flexible. It needs to be able to innovate. It needs to be able to, basically, make profits.

Hon. John McCallum: Okay. Does anybody disagree or want to comment?

Prof. Ian Lee: I'll be brief. It pains me, because you were a very distinguished economist at McGill, and I am very respectful of your position, but I have to disagree. I don't believe it is the role of Parliament or legislators to pick winners and losers. If I understood you, you were suggesting creating some mechanism or policy that would give a bias towards Interac so that it could beat or defeat MasterCard or Visa. If that is the argument, I hope you don't, because it's not the ownership of the company but the value and benefits it brings to consumers that should be the driver of the policy.

On the second issue, I agree. The Interac governance structure is archaic and inefficient and should be changed.

The Co-Chair (Hon. Michael Chong): Thank you very much.

Go ahead, Mr. Carr, just briefly.

Prof. Jack Carr: Briefly, I can't see how competition could hurt. Whether you want to loosen regulation on Interac is something else. I hear merchants saying that if Interac comes in, it's going to charge a higher price and take over the system. That's inconsistent. It's hard to believe that a competitor could come in, charge a higher price, and take over the system. It is competitors that are more efficient and charge lower prices that can take over the system. You can't have it both ways.

The Co-Chair (Hon. Michael Chong): Thank you very much, Mr. Carr.

We'll go to Monsieur Laforest.

[*Translation*]

Mr. Jean-Yves Laforest (Saint-Maurice—Champlain, BQ): Thank you, Mr. Chair.

Good morning to all our guests.

I will ask you a rather direct question to start. Are you in favour of tighter or increased general regulation of the credit card and debit card systems, as described by Mr. Scholnick?

You can each take a turn in answering.

● (0950)

[*English*]

Prof. Barry Scholnick: The question was tied to regulation, and I think my views are similar to my fellow economists. When thinking about regulation, be very, very careful. It seems to me there's a hierarchy of different things, when you're thinking of regulations to resolve this issue, that government as a whole could lose. I think everybody's in agreement about issues such as transparency. Everybody's in agreement about issues such as financial literacy. That's not a debate.

[*Translation*]

Mr. Jean-Yves Laforest: I will raise another similar point. Last week, we learned that as far as regulation is concerned, there is no definition of electronic currency in Canada, nor in Quebec. This is a major point in the context of the electronic payment card system. Yet, Canada does not have a definition of electronic currency.

Do you not believe that this is a significant problem to resolve and which would force, at the very least, authorities to better define the terms that we are talking about? My question is for all of the witnesses.

[*English*]

Prof. Ian Lee: If I could respond, yes, there is a role for legislators to create the rules of the game that govern all of the institutions in the game, and the metaphor I use all the time is that you are the referees in the hockey game. If we can imagine a hockey game between the Toronto Maple Leafs and the Ottawa Senators, we don't want the referees to jump on the side of the Toronto Maple Leafs. Even though they need a lot of help, because they're a bad team, we don't want them to bias the game in their favour. We want them to be independent, neutral, and non-partisan in creating a neutral platform, and not favouring one player over another.

Prof. Jack Carr: There's plenty of regulation in the Canadian Payments Association and whatnot. The question, I think, before this committee, and what the retailers want, is regulation of the interchange fees. The question is why? What's the problem? As far as I see, interchange fees have been stable in Canada for a long period of time. There's a strong economic rationale as to why you need interchange fees. My colleague has shown a large number of examples of cases in two-sided markets, and therefore I think there's an economic reason for it. There's no economic reason to regulate interchange fees.

[*Translation*]

Mr. Jean-Yves Laforest: None of you provided information about your studies or observations. Nobody talked about the effects of loyalty programs. You talked about premium cards, you claimed that consumers are the winners, and that premium cards provide bonuses. But there is a motive behind all this—it is called customer loyalty. Nobody talks about this in concrete terms.

I believe that Mr. Scholnick talked about platforms. You compare all of them, including the Visa platform, and the real estate listings platform. However, these things are very different; profit margins for those platforms are very different. In the real estate market, for example, brokers earn commissions that vary between 5% and 10%; merchants on the other hand have very thin profit margins which make things all the more difficult when interchange fees rise. when you paint all these platforms with the same brush, I find the comparison to be a bit unfair.

[*English*]

Prof. Barry Scholnick: I think that's an excellent question. I think when you're thinking about platforms, platforms are very different. Some platforms can be competitive with other platforms, and the example would be shopping malls. When you have one mall and another mall in the next suburb, if the shopping mall owner makes the retailers unhappy, they'll move to the next suburb, to the other shopping mall. It's still a platform. However, the interesting issue with the Visa and MasterCard platform is that right now they are dominant. They have an extremely high market share and everybody has to use them.

So you're absolutely right that different platforms have different levels of success, but I think when you're thinking about platforms, the issue is that there's always around the corner—possibly, maybe—another platform that can come in and compete against them. We don't know, but I think maybe through technological change, through the Internet, through organizations like PayPal, or other kinds of systems, they will possibly reduce—

● (0955)

[*Translation*]

Mr. Jean-Yves Laforest: I have one last question. You all compare the systems, but none of you provided an analysis of what would happen if nothing were to be done. I think that both issuers and acquirers make a lot of money. Merchants are the ones who are complaining that profits are falling and that increases are causing difficulties.

The credit card system is like the goose that lays golden eggs. You said so yourselves. Sales increase, everyone seems to be a winner, but has anyone thought about what would happen if there were no regulation? What would happen if there were a total hands-off approach? Has anyone carried out an interesting study, or forecast that we could obtain? When the goose that lays the golden eggs is over-exploited, it will die.

[*English*]

Prof. Jack Carr: We certainly have, as far as interchange fees, a laissez-faire approach. A number of countries do in fact have the laissez-faire approach. As far as I can see, the system is working. The interchange fee, which has been complained about by the retailers, certainly changed in complexity in April 2008. If you look at a weighted average of interchange fees before and after, I understand there's almost been no change. It was 1.58% on average before and it's 1.6% on average now. With all averages, some retailers are worse off and some retailers are better off.

Let me get back to your thing on loyalty programs. You said nobody asked or answered questions on loyalty programs. Loyalty programs exist in a number of industries, and they are a marketing method by which banks, issuers, get customers. They seem to work. That's why they use them. We as economists really have no expertise in designing loyalty programs or designing marketing programs, but we know firms out there will design programs that bring in customers. They appear to work, and there doesn't appear to be anything wrong.

With the merchants, what some merchants don't appreciate is that these programs sign up more customers and bring in those customers to their store.

[*Translation*]

Mr. Jean-Yves Laforest: Mr. Carr, we already heard that.

[*English*]

The Co-Chair (Hon. Michael Chong): Thank you, Mr. Carr.

[*Translation*]

Thank you, Mr. Laforest.

Mr. Bernier, you now have the floor.

Hon. Maxime Bernier (Beauce, CPC): Thank you, Mr. Chair.

I wish to say that each one of your presentations was very refreshing. I agree with you, I think the system works. Capitalism works, individual freedom is good, and there is no problem. I do not understand why we need to meet any further since we have realized, along with you, that there is no problem. And the beauty in all this is that companies are making money. In a capitalist system, profit is healthy, as it creates wealth and jobs.

When we politicians seek to regulate or legislate individual behaviour, as we are wont to do, each law or regulation that is enacted gives a privilege to a specific group. In this case, we would be giving preferential treatment to certain groups, to the detriment of others. Personally, I prefer to let individuals be free to choose.

Nonetheless, I have an economic question about our system, and I ask it so that our system will continue to operate as it does currently, that is, extremely well. Are there any barriers to enter this industry? I am referring specifically to fees or the platforms that are now in effect. If a competitor seeks to break through the market, would they be free to do so, or have politicians and legislators created obstacles to enter this market?

Mr. Laforest asked what we should do for the future. I, for one, believe that we must make sure that there is no barrier to entry, so that future competitors may enter this market. I would like to hear your opinions on this subject.

[*English*]

Prof. Ian Lee: Clayton Christensen is a professor at the Harvard Business School who has written on innovation very extensively as the most important form of competitive advantage in a business. That's the way I teach strategic management, where we deal with these questions of how to create value in a business and how to attract customers, as Professor Carr was saying. You use innovation, and it could be innovation in loyalty programs or pricing, or in services around the product and so forth. There's a myriad of ways to differentiate the product, to create value, to attract the consumer, and to deliver a competitive advantage.

Christensen has noted over and over that often when innovation comes—disruptive innovation or radical innovation—it comes from a player outside the industry who changes the rules of the game and comes up with a brand-new technology that has similar functionality. I'm agreeing with your comment that when government enters or the legislators put barriers, impose artificial barriers, you're going to inhibit the innovativeness of our economy. It is CATA, the Canadian Advanced Technology Alliance, that points out that we are lagging behind most of the western world in terms of our innovativeness. Some faculties, some professors, believe it's due to excessive government intervention that regulates the innovative capacities of our businesses.

● (1000)

The Co-Chair (Hon. Michael Chong): We're going to go to Mr. Carr and then Mr. Ware.

Prof. Jack Carr: I think the system is working well, and we do want to allow as much competition as possible. We also have to realize that there are economies of scale, so within any platform you're not going to have a large number of players, but within that system we have within, say, the Visa or MasterCard system, competition between acquirers and competition between issuers. So there is that competition, and you want to encourage as much of it as possible.

You have competition between payment systems too, which has to be stressed. The payment system that used to be used 40 years ago was cash and cheques. There was a sort of natural monopoly; that has disappeared, and Visa and MasterCard have grown dramatically, not because of artificial rules they have, but because they have provided a better mousetrap. They provided a better product, so they took over from both cash and cheque, and now you have debit and credit cards.

The point you mention is that what Parliament has to worry about is that you always have groups coming to you seeking regulation. Adam Smith, back in 1776—and John McCallum would appreciate this—said you have to worry about merchants and workers coming to you asking for legislation in their favour, which, like tariffs or regulation, would benefit them. That is what you classically see here. Economists call it rent-seeking. You have a system that is working, but merchants and retailers see an opportunity to gain against the system and to improve even better.

I feel bad for the retailers because currently the economy is doing badly, and retailers, along with everybody else, are hurting. But the economy will pick up; they'll be better off. But you don't want to regulate a system and be left with rules that cause an inefficient means of payment. You'll be stuck with that forever, and the price you pay for giving gifts from one group to the other is an inefficient system that's costly to the economy, that reduces the per capita GDP for Canada, and that clearly can't help. Laws that result in inefficient systems are bad laws.

The Co-Chair (Hon. Michael Chong): Thank you very much, Mr. Carr.

Mr. Ware.

Prof. Roger Ware: Just very quickly, in the debit area, what government needs to do is reduce the barriers to entry and encourage entry, as I said earlier. If they achieve that, then we will get more competition and consumers will benefit.

In the credit area, just to follow on from one thing Jack Carr said, yes, 40 years ago we had cheques and cash and then credit cards had a huge successful run. Although we're not likely to get a new credit card network entering because the network economies are just too large, one thing I would predict, for example—and we never can really predict innovations—is we will start to see a lot of online debit transactions in the future, because, for example, the Interac card has not been used for online transactions. I think it's a security issue. That's going to change, I expect, and that may in fact reduce credit card use, but as Jack said, that's innovation and that's efficiency, and that's what we want to encourage and allow.

The Co-Chair (Hon. Michael Chong): Mr. Scholnick.

Prof. Barry Scholnick: If I could just comment following up on Professor Ware's comments about innovation on the Internet, one of the more important recent developments technologically is the emergence of this organization called PayPal, of which this committee might or might not be aware. This flowed from eBay, where individual buyers are selling to individual sellers. There are no merchants. There are no big organizations. These are private individuals selling to each other, and you couldn't set up a credit card arrangement between these two individuals because you are a private person and you can't set up a credit card account so that people can pay you. What PayPal did was to set up a system, which is beginning to take off and potentially could become very big and very important as eBay grows, which is in direct competition to Visa and MasterCard in this niche of payment on eBay over the Internet. It's a new platform. I think we will have more and more of these new platforms competing with Visa and MasterCard.

● (1005)

The Co-Chair (Hon. Michael Chong): Thank you very much, Mr. Scholnick.

We will now go to Mr. Mulcair.

[*Translation*]

Mr. Thomas Mulcair (Outremont, NDP): Thank you, Mr. Chair. I hope that your watch, that you used to time your colleagues from the government side, and which must resemble a painting of Salvador Dali and is stretching out your perception of time, will be the one you use when timing questions to be asked by the official opposition.

[*English*]

The Co-Chair (Hon. Michael Chong): Mr. Mulcair, the order of speaking and the length of time is actually at the discretion of the chair, as per the routine motions of this committee—

[*Translation*]

Mr. Thomas Mulcair: Yes, but I only hope that you use your discretion to show equal concern for the opposition and your Conservative colleagues.

[*English*]

The Co-Chair (Hon. Michael Chong): —so I can assure you that time has been fairly allocated.

Mr. Mulcair, you have the floor. Go ahead.

[*Translation*]

Mr. Thomas Mulcair: Mr. Carr, Mr. Scholnick, Mr. Lee and Mr. Ware, good morning and welcome.

I will begin with you, Mr. Carr, because earlier, you tried to dodge the question about loyalty programs. You said that you are an economist, and do not deal with matters like that.

I also want to thank you for stating from the outset, in a very transparent manner, that your work was sponsored by Visa.

I do not think that you can easily evade the issue of loyalty programs. Take, for example, a television ad that is now running, in which two women are leaving a supermarket, both pushing a shopping cart full of groceries, and one turns to the other and says that she paid with her Visa card from a certain bank, and received a $2 cashback on a $100-purchase. The other woman tilts her head and says that it's rather trivial. The first woman asks her how much she got back, and the second one says nothing because she paid with cash.

Therefore, it leads one to ask: Who else paid for the $2 cashback to the first woman, if it is not all consumers, including the ones who use cash to pay for increasingly expensive grocery items? Who paid for the $2 the woman got back because she used her Visa card?

[*English*]

Prof. Jack Carr: Let me answer your question.

First of all, you implied that my research is financed by Visa. I announced that, and it's certainly the case. But like loyalty programs, professors have brand names. I say what I believe. If the message is consistent and Visa wants to subsidize it, that's clear. But I believe in 100% transparency, and I told you that.

Second, on loyalty programs, what I said was that as an economist I wouldn't know how to design a loyalty program. But I know that they exist in many different industries and they're there.

Now your key question was, who pays? The interesting thing is you assume. Clearly, when people look at costs with credit cards... and one of the reasons why credit cards are more costly is because it costs something to bring those customers in, and the way you bring the customers in is you give them these points and loyalty programs. But the other part of the equation, when you look at the system, is the efficiency gained by bringing them in. When I take my card and I get 2% cash back at the pumps, what I find is that I can do that transaction, and for the merchant, it's much cheaper. I don't have to line up and pay cash. The merchant doesn't have to add cash. So it's more efficient.

The second thing is this. I recently bought an Air Canada ticket with my credit card for a year from now. Now, without the credit card, I wouldn't have done it. Why? Even I wouldn't have paid cash, because I'm worried that Air Canada won't be here a year from now. They may be bankrupt. But with my credit card and with that premium credit card, what they give me is insurance. They give me insurance that if Air Canada goes under, and they can't default—

Mr. Thomas Mulcair: Thanks, Mr. Carr, but that wasn't the question.

Prof. Jack Carr: No, no, but that's the—

Mr. Thomas Mulcair: Hold on, Mr. Carr.

The affirmation was made that it's an urban legend that people who are paying cash are somehow subsidizing people who are paying with credit cards.

● (1010)

Prof. Jack Carr: That's correct.

Mr. Thomas Mulcair: In the advertisement where two ladies are walking out with their carts, one of them says she just got two bucks for her $100 purchase off her card. My question to you is, who's giving her the two bucks?

Prof. Jack Carr: You're assuming, though, that it's just as efficient to use cash. Yes, there's the $2 paid for that $100 transaction —

Mr. Thomas Mulcair: You're still not answering the question.

Prof. Jack Carr: I'm trying to answer your question.

Mr. Thomas Mulcair: You're not answering it, so—

Prof. Jack Carr: Okay. If you stop me—

Mr. Thomas Mulcair: —so we're going to go somewhere else.

You're not a victim, Mr. Carr, but we will go somewhere else.

Mr. Lee, I have a question for you, and it does have to do with the economics, but it also has to do with the public policy.

I'm working in a business and I'm buying a $40,000 piece of equipment. It's my business. The person I'm buying from says they have a bonus this month and they're giving back 2% cash. I take the $800. If I don't declare it, I've just committed an offence under the Income Tax Act, if I'm trying to deduct the whole forty grand.

Or I'm the employee of somebody's business and a client says they've got a special this month and they can deliver a flat screen TV worth $800 to my cottage if I'm buying this particular piece of equipment. If I do that, I've committed a fraud on my employer.

We've just described how much fun it is to get bonuses, to get the 2%, and why not 4%? How do you deal with that, in terms of public policy, when you've got a lot of people.... I have a friend who's a medical professional. Last year he took a $25,000 trip all on points—hotels, everything—because everything he buys in his medical practice, a lot of equipment, he puts on a credit card. Last year that amounted to about $25,000, for a couple million bucks of purchases.

Where is that money accounted for, and is it taxed? Or is this just an entry-level kickback scheme that society has decided they're going to accept?

Prof. Ian Lee: Actually, I would take the opposite tack. It is a reduction, a discount on the purchase. People who buy big ticket items know this: that when they go into the car dealership, they can negotiate a deal better than some other customer. So this is a diminution.

Mr. Thomas Mulcair: But if somebody is declaring a $40,000 expenditure and they have in fact got $800 back in points to buy another trip and it's not declared, why is that less of an offence under the Income Tax Act than the case of a person who gets $800 cash? Why is one morally, ethically, or legally different from the other? I put it to you that it's not.

Prof. Ian Lee: I'm not dealing with the Income Tax Act. I am not a tax accountant, nor a tax lawyer. I'm dealing with the strategic decision by companies.

Mr. Thomas Mulcair: But isn't it part of the consideration we have to have? Mr. Carr wants to duck the issue, saying that these loyalty programs have nothing to do with him, that he's an economist.

Prof. Ian Lee: I don't want to duck the issue. I want to confront it head on. I just don't want to deal with the tax issue. If you want—

Mr. Thomas Mulcair: Well, what's the difference between getting $800 cash back and not declaring it to the income tax department and getting $800 cash in the form of trips and so on and not declaring it? Is there any fundamental difference between the two?

Prof. Ian Lee: First off, when you're buying something, you're buying it out of after-tax income. If I buy an airplane ticket, and then you, as Parliament, want to tax me on the savings, you're taxing me twice, because I've already bought the ticket out of net income.

Mr. Thomas Mulcair: I don't think that works, Mr. Lee. In the example, I have $800 cash as a kickback for the purchase of a $40,000 piece of equipment. We all agree that if the person takes the $40,000 and applies it as a business expense, they've just committed an offence under the Income Tax Act.

If I buy the same $40,000 piece of equipment and put it on a credit card and get $800 back in the form of.... There is one bank that even lets you buy RRSPs with the 2% you get back on their credit card, and then you're getting a further tax decrease on that. And that's all money lost from the economy.

How is it possible to discuss this whole issue without looking at the effect of those on the bottom line of the government and at the lost taxes?

The Co-Chair (Hon. Michael Chong): Thank you, Mr. Mulcair. We're out of time on this round.

Perhaps you can answer very quickly.

Prof. Ian Lee: I'll respond to it very quickly.

There are loyalty programs throughout the economy. At Carleton University we have coffee shops and they give out a card, which they punch every time you buy a coffee, and the tenth coffee is free. It's the same concept as getting a discount on your credit card. It's called discount for volume. If you patronize that business more than another business, I'm giving you an incentive to come back to my business over and over, and that's the value creation; that's the growth to my business as a business manager.

The Co-Chair (Hon. Michael Chong): Thank you, Mr. Lee.

Mr. Rota, you now have the floor.

Mr. Anthony Rota (Nipissing—Timiskaming, Lib.): Thank you, Mr. Chair.

There were a couple of comments made, one in particular, that I found a bit disturbing. It had to do with the system as we have it still working and there not being a problem yet.

As parliamentarians we have to look at the good of all society, and I just want you to realize that the fact it's working now doesn't mean that down the road it may not be working. If we see something coming up, I think we want to look at it to prevent any possible problems, for the betterment of everyone.

The system as it stands right now is that you have the providers, who are the card issuers, and you have the banks and the consumers, who are basically the customers of the providers. Under a competitive system where you have two major cards, the providers are vying for the business of the banks and vying for the business of the consumers so that they will take their cards.

The one thing I find very disturbing is that when they're vying for that business, they offer more benefits. They offer to differentiate themselves. And how do they do that? I think Mr. Mulcair asked the question, "Who pays for it?" It's at the expense of the merchant.

I know the argument will be that the merchant is selling his or her receivables and that this is the cost they pay. Usually, when you have a cost, you can negotiate something and it's fixed.

You mentioned Adam Smith earlier. I believe that in the economy Adam Smith dealt with, things were much simpler. You had to have the same product. It's been a few years since I've studied Adam Smith, but basically the economy, in his view, has to be pretty well level: you have similar products and a relatively barrier-free entry into the market.

In a system like the one we have with the banks, in which you have two major players, the merchants are basically the pawns in all this, and the costs are passed on to the merchants, who have to have this service. Do you not find there is something wrong with this system?

● (1015)

Prof. Jack Carr: I'll respond to that. There are a number of points you made, and let us hope I get all of them.

Let me get to the Adam Smith point that I made about people lobbying government. That occurs all over the world; it has occurred since 1776 and it occurs today. People act in their own best interests —that was Adam Smith's point—and if you have government setting rules and regulations, they'll try to get the rules set in their own interest. That hasn't changed. The nature of the economy is much more complicated, but that fundamental fact is still the same.

On these systems, I think it's important to stress, when one has to understand how it is and who bears the cost, what happened 40 to 50 years ago. Only cash and cheques were used. Then credit cards came along. Credit cards could only survive if they innovated, if they were more efficient. An example I gave is, if I go to Tim Hortons and swipe my credit card, it's fast; or if I go to service stations, it's faster —it's more efficient. They need fewer employees to take cash, if I do it myself. I can make online transactions.

When you have innovation and it's efficient, the new system can offer the product with more benefits at a lower cost. You ask who pays for the benefits. No one does. They result from building the better mouse trap. If you build a better mouse trap, you can sell it cheaper and give a better product. This selling the cheaper.... As Professor Lee said, when you give the loyalty programs or you give all these benefits, the customer is getting it cheaper, because it's a superior product—not in all transactions, but in a lot of transactions.

That's how credit cards could survive. They provide a better product at a lower price. The merchants only see these benefits being given to the customers; they don't see that these transactions are being done more efficiently and that these customers are now being brought in. That's the gain.

The Co-Chair (Hon. Michael Chong): Mr. Lee, did you want to add—

Mr. Anthony Rota: Can I go to Mr. Lee? I have a question for Mr. Lee, and it will probably lead right into this, if you don't mind.

Prof. Ian Lee: Can I respond to that?

The Chair: Go ahead, very briefly, so that Mr. Rota can move on.

Prof. Ian Lee: You said one thing that caught my attention. You said the merchants are pawns, implying that they have no choice. I will test your theory. Is any merchant forced to take credit or debit? No, they can take cash or cheque, but they choose not to because they know deep down that cash and cheque are far more expensive than debit or credit. That's why they're taking it.

Mr. Anthony Rota: This leads me to my question. You mentioned again that cash and cheque are more expensive, or that debit and credit was cheaper. What I have here is a study, a discussion paper by the Bank of Canada, that looks at a transaction that is about $36.50, which is about average, and shows that the average cash transaction cost is 25¢, debit comes in at 19¢, and credit at 82¢. It's more than three times the next level.

What you're arguing, basically, is that credit is much cheaper. What I fear with the debit, if it goes to a percentage basis, is that all of a sudden you're just changing money from one place to another, yet you're charging a percentage, and it can become quite substantial. In fact, it's more than three times as much.

The argument is that with the better card, the incentive card, people will spend more money. There is an argument for that. I don't agree with your assertion that the use of card payments can stimulate impulse, especially on larger purchases.

However, this doesn't apply to certain categories, such as grocers or gas retailers, who must contend with very small margins as it is. What we've effectively done is take a fixed level of consumption, and I don't think it's really fair to those consumers that they should have to pay a higher rate on an interchange rate that offers all these benefits. They have very thin margins. They don't have a choice whether to choose to accept the base model or the Cadillac model, for lack of a better word.

● (1020)

The Co-Chair (Hon. Michael Chong): Thank you very much, Mr. Rota.

Be brief, Mr. Lee, before we move on to Mr. Dechert.

Prof. Ian Lee: I have two quick responses.

I have looked at several studies, including the Bank of Canada study, and I have looked at it with a couple of chartered accountants from the school. I believe that every study that's been done on the cost of payments has radically under-estimated the cost of cash, because they have not factored in the cash custody required—safes, two people counting the cash, and so on. I think the cost of cash, although I can't give you a number, is probably double or triple or quintuple, because there has not been a full cost-benefit analysis using the kinds of techniques that the PBO has used, using full cost accounting. That's my response.

The Co-Chair (Hon. Michael Chong): Thank you, Mr. Lee.

Thank you, Mr. Rota.

Mr. Dechert.

Mr. Bob Dechert (Mississauga—Erindale, CPC): Thank you, Mr. Chair.

On a point of information, I think if Mr. Mulcair were to actually read the Income Tax Act, he would find that the use of a credit card reward point of any kind on rewards earned on a corporate transaction is a declarable taxable benefit. That's been in the Income Tax Act for many years, I believe.

Gentlemen, thank you very much for your presentations. Has any of you studied the interest rates charged by credit card companies and the relationship between the rather high rates of 19% to 20% often charged on these credit cards and the prime interest rate? In your view, what is the average effective interest rate earned by the banks and the credit card companies on these rates?

Prof. Ian Lee: I have looked at it. In fact, DBRS has a beautiful study that came out only three months ago. Remember that 70% of all cardholders pay off their credit card in full within the 30-day interest-free period, so they're not getting the 19%. Their effective gross yield is 13%; then you deduct costs of funds and you deduct the charge-off rate. Of course it varies over time in terms of the cost of funds and the cost of charge-offs; right now the cost of funds is low and the cost of charge-offs is skyrocketing, but the net is somewhere around 5% when you take off the cost of funds, the cost of charge-offs, and the cost of running the business.

This is what people are missing. They look at that big number of 19% and say “Oh, my goodness”, but they're not getting 19%. They're only getting 13%, and they have to pay for the charge-offs, they have to pay for the cost of funds, and they have to run the business. That brings it down to somewhere in the 5% range, and I don't think anyone would argue that a 5% return is outrageous.

Mr. Bob Dechert: I see.

The Co-Chair (Hon. Michael Chong): Thank you, Mr. Lee.

Mr. Carr, did you have something to add to that?

Prof. Jack Carr: I haven't got any studies, but I am a monetary economist. Recently what's happened is that the prime has fallen because of the fall in economic activity, but the risk in the credit card business has also gone up. You would not expect to have a one-to-one correlation between the fall in prime and the fall in the interest rate charged on credit cards. It's more expensive now, given the high risk among those cards. That has to be taken into account.

When you have no change in the risk, you would expect closer correlation, but when they move in opposite directions, you wouldn't expect them to move together.

Mr. Bob Dechert: Thank you.

Gentlemen, a number of the retail organizations have told us that the contracts they enter into with credit card companies often restrict them from advertising the cash discount price. Some of the credit card companies deny that's the case, but there seems to be some discrepancy there.

Have you studied what the impact would be of retailers advertising a cash discount price in all transactions? What percentage of consumers do you think would be likely to take them up on that cash discount offer if it were offered?

Prof. Jack Carr: I haven't studied it and I don't know this dispute. All I know is that credit card companies tell me that you can do it. We know it can be done in Australia. There's no change. We know here it can be done—

Mr. Bob Dechert: The question is, can you advertise?

Prof. Jack Carr: In Canada I have received discounts for cash, and I've seen it advertised, so there doesn't appear to be a problem. However, it's still rare, and you have to ask yourself why it is rare. In Europe it's rare. The argument has to be that it's rare because cash is costly, and therefore you don't want to put people.... In some places it's used, and for certain transactions as well.

Mr. Mulcair worries about avoidance of income tax. Cash is one of the clear ways of avoiding income tax. If you want to pay for something and avoid income tax, you pay in cash. That becomes a problem, and retailers may want to steer you to cash exactly for that reason.

● (1025)

Mr. Bob Dechert: Presumably if consumers knew that they had a cash option, maybe more would take advantage of it.

I want to ask Professor Scholnick a question. I was rather interested in your analogy of a shopping mall as a platform provider. I know that mall owners often charge a base rent plus a percentage of sales done by the merchants in those malls. How do those fees compare with the actual cost of providing the mall facilities, for example?

Prof. Barry Scholnick: I'm not an expert on shopping malls, but the economic argument for the notion of a shopping mall as a platform is the agenda of the mall operators. Their game is to bring in lots of merchants and lots of shoppers and provide this platform. The second part of their business model is to then extract money. These are businesses. They want to make as much money as possible. That's their job.

The interesting part is who they extract the money from. What you don't see is that when shoppers walk into the mall, shoppers have to pay to get into the mall. What you have is the shopper coming in free, but the merchants and the shops in the mall are paying for essentially all the facilities that the mall provides.

The Co-Chair (Hon. Michael Chong): Thank you, Mr. Scholnick. Thank you, Mr. Dechert.

We'll briefly hear from Mr. Carr.

Prof. Jack Carr: Taking a percentage of sales is a very astute observation. It's equivalent in economics to what we call share-cropping, another process in which you take a percentage. The percentage is done to give the right incentive to the mall owner to put in the right mix of stores. As a retailer, you don't want another restaurant right beside you. You don't want another store competing.

By giving the owner part of the rent in a share, they want to maximize the total revenue of the mall. Allowing them to take that percentage gives them the right incentive. It's almost like an interchange fee; it provides the correct incentives to the various parties.

The Co-Chair (Hon. Michael Chong): Thank you, Mr. Carr.

Monsieur Vincent.

[*Translation*]

Mr. Robert Vincent (Shefford, BQ): Mr. Chair, I will be sharing my time with my friend Mr. Robert Bouchard.

Earlier, my colleague asked if any real action had been taken over the years. He also asked you if you had a study to support the position you hold, according to which everything is fine, life is great, and things should continue as they are. Yet, you have no study, and you did not answer his question. Therefore, we can deduce that since you have no study, your position is simply a personal opinion that you are sharing with us today.

Mr. Lee, you stated that merchants do not have enough competition to earn the 2%. What do you think Visa and Mastercard are doing? These two companies are in the market and are charging interchange fees of 2%. They do not need competition and they can charge any interchange rate they want, change it when they want, and there will be no state intervention.

If someone wants to open a restaurant and earn a 3.8% profit on the meals, they will really only earn 1.8% if a client uses a credit card. Since you are a banker, can you tell me if it would be advantageous for a bank to lend money to someone who wants to open a restaurant? You may answer that a restaurant is free to choose whether or not it will accept credit cards, but if it does not, people will go eat elsewhere.

We are caught up in a system that the banks and the caisses populaires have created by deciding that people's paycheques would systematically be deposited into accounts from which money can be drawn any time. If somebody wants to travel, a credit card is needed to make reservations. If someone wants to go somewhere, a credit card is needed to reserve a spot. This is a credit card monopoly, a spiral in which we are stuck that was created by the banks and the caisses populaires.

Therefore, Mr. Lee, when you say that we need to be more competitive, I cannot help but be a bit skeptical. I do not believe that we can get out of this.

Can you explain to us how we can get out of this?

[*English*]

Prof. Ian Lee: I will answer the question you said I didn't answer—what would happen?—and then I'll come to your present question.

What would happen if nothing is done in terms of price regulation? The trend is very clear. From the empirical data, the percentage of transactions accepted by cash or cheque is going to continue to decline. Some day, in the not-to-distant future, I believe cheques and cash will disappear. That's what I believe, based on the empirical data. That's point one.

Number two, in terms of Visa and MasterCard, I'm assuming we will not regulate prices in that section of the economy. The phrase I use with my own students about wage and price controls is that you cannot regulate, put price controls on one sector, because all the sectors are independent, or, to put it more colloquially, you cannot be half pregnant. It's all or not all. You cannot regulate one sector of the economy, because they're buying inputs from other sectors of the economy. The credit card companies hire people. They buy technology inputs. They buy broadcast wires, Internet wires. So because they're interconnected with everybody else, if you regulate the prices in one sector, you have to regulate everybody.

In terms of the third point, the merchant does not have to accept credit cards or debit cards. If they feel so strongly that this is really unfair, they can demand that every customer pay cash. They could have said to me when I bought my dishwasher, “You have to pay cash.” And I could have said, “I'm not going to patronize your business.”

● (1030)

[*Translation*]

Mr. Robert Vincent: I'm sorry, Mr. Lee, but you can't turn a client away because you won't accept his credit card. He'll find another place to eat. It makes absolutely no sense to think in this way, Mr. Lee. That is not how people do business. And I think you are smart enough to know that.

[*English*]

Prof. Ian Lee: I agree.

[*Translation*]

Mr. Robert Vincent: Did I ask you anything, Mr. Bernier? Mind your own business, and I will mind mine.

The Co-Chair (Hon. Michael Chong): Mr. Vincent, you have the floor.

[*English*]

Prof. Ian Lee: Mr. Vincent, I want to answer your question.

I think you're recognizing what I'm saying. It is in the self-interest of merchants to accept business credit cards and debit cards because it enhances and augments their sales. If they didn't take them, their sales would go down and they would probably go bankrupt, and they don't want that.

[*Translation*]

Mr. Robert Vincent: I agree with you, but you cannot say that we have to set the interchange rates at 45¢ or 50¢, for instance, each time a credit card is used, instead of paying 2%, because Visa and Mastercard, the credit card issuing companies, have established their rate at 2% for the time being, but there is nothing to prevent it from rising to 3%, 4% or 5% overnight. There is no competition in this field, there are only two players. Obviously, if the goal is profit-making, they work together and there will be no competition between them.

How can you expect there to be competition between merchants when credit card issuers can do whatever they please, when there are no regulations and when we accept that market rules remain unchanged? It doesn't hold water. We must regulate, and do so straightaway because credit cards are going to force merchants to go under because of costs.

The Co-Chair (Hon. Michael Chong): Thank you, Mr. Vincent.

[*English*]

We'll hear briefly from Mr. Lee and then Mr. Carr, and then we're going to move to Mr. Menzies.

Prof. Ian Lee: You said there is no competition and there is no alternative. Well, somebody called Bill Gates was quoted only six months ago as saying he could go into the debit card business because he could do it more cheaply than anybody else.

If they set their fees too high, any of the companies, this is going to provide an enormous incentive to some entrant to enter the business and knock them dead with a lower, cheaper, better-value product. This happens all the time. Schumpeter called it creative destruction. If you put in price controls, you end creative destruction. You end innovation. Then we'll look like Cuba or some country like that.

The Co-Chair (Hon. Michael Chong): Thank you, Mr. Lee.

We'll have Mr. Carr, briefly.

Mr. Carr, you have the floor.

Prof. Jack Carr: Mr. Vincent, you said there's no study of a system with no regulation. Well, we do have, currently, no regulation. We have our experience of the last 30 or 40 years. In the last 30 or 40 years, interchange fees have not changed at all. The nature has changed, but the average interchange fee is the same.

You talk about interchange. How do we know that it won't go up? It's stayed the same, and it's stayed the same because it's set to balance the system. Visa doesn't make more money by charging more interchange fees. It's done in order to take account of the fact that they want to provide the correct incentives to the card issuers. If it went to 10%, they would not make one cent more.

The Co-Chair (Hon. Michael Chong): Thank you, Mr. Carr.

Go ahead, Mr. Menzies.

Mr. Ted Menzies: Thank you, Mr. Chair.

Thank you for this lively debate. I'm quite excited to hear the fact that the marketplace still does work. It's not just me that believes that. We have some other people out there who believe that the marketplace can work.

In a previous meeting, I suggested to the Canadian Bankers Association and some of the banks that we didn't want to regulate this, and the media spun it as me chastising the banks. Well, if the truth be known, I was speaking broadly to all those involved in this industry. They shouldn't be ashamed to make money on this system, because customers demand it. They demand this system, and I'm glad to hear that there are some options out there.

When we hear about the 6% in debts that are written off.... We're proud of our banks. Our banks are in good condition, but they're carrying more risk now, and they have no collateral for that risk. We want to make sure that we don't put in a 5% maximum interest rate on these cards and that we don't over-regulate. Some of you have suggested that we've already gone too far, but others of you have suggested that what we're doing with financial literacy is important and that we make sure that consumers are treated fairly.

Have we gone too far? Is the market working?

I'd like some comments, if I could, from whoever might be interested.

● (1035)

The Co-Chair (Hon. Michael Chong): Go ahead, Mr. Scholnick, and then Mr. Carr.

Prof. Barry Scholnick: In terms of regulation, I was reading the transcripts of the Senate hearings a few months ago on this issue, and I think the most interesting thing for me, certainly, that came out of that meeting was when the senators talked to people from the Competition Bureau. What came out was that the Competition Bureau, the competition authorities in Canada, are currently looking at the system, particularly under the Competition Act and the particular clause that talks about abuse of dominant position. I think this is completely appropriate, and I was intrigued to hear this.

In other words, if there is a problem in the system, the relevant authority to be looking at this is the Competition Bureau, whether it's abuse of dominant position or whether Visa or MasterCard are doing things illegally. Because if they are abusing their dominant position, this could be a criminal offence and they could be taken to court. Similar competition-driven court cases have happened in Europe and have happened in the United States.

So I think the playing field where things should be happening in terms of the role of government is in the Competition Bureau and the Competition Tribunal.

As I think the people from the Competition Bureau told the senators, these things take time. It's very data-driven. They have to examine the issues very carefully. But I believe the good news is that they are looking at that. I think this is the appropriate field for this to be happening in, rather than having Parliament or even the Bank of Canada being involved in regulation.

The Co-Chair (Hon. Michael Chong): Thank you, Mr. Scholnick.

Mr. Carr, and then we'll go back to Mr. Menzies.

Prof. Jack Carr: Given that full disclosure is an issue, I should disclose that I did my Ph.D. under Milton Friedman at the University of Chicago, and I'm a firm believer in the principle of operation of markets.

The market is working, and if you take a look at the Canadian banking system, it's the envy of banking systems all over the world. We're being examined by the Americans, by the Europeans—as in maybe we should go towards the Canadian banking system. We have a few banks with a large number of branches, as opposed to the United States, which had a huge number of banks with no branches. Their system didn't work.

During the Great Depression, 5,000 U.S. banks failed; not one Canadian bank failed. We have a system that's working. Our payment system is working, our banking system is working, and it's regulated. We shouldn't put more regulation in it on such things as interchange fees, which make it not work, which make it inefficient. We have a system that is working. If it ain't broke, don't fix it.

The Co-Chair (Hon. Michael Chong): Thank you, Mr. Carr.

Mr. Menzies.

Mr. Ted Menzies: My next question would be to a reference Mr. Scholnick made to cellphones. I appreciate the fact that this system isn't broken, but can we make it better? I'm assuming you're referring to the African model, where they're using phone cards. Perhaps you could explain how that debit/credit system is actually working.

Prof. Barry Scholnick: Thank you.

That's a really excellent question, and I think it ties into my key point to this committee, which is that a change will happen not through regulation, but through innovation, through new developments, through technology.

The example you give is cellphones and the African model. In places like Kenya and South Africa, what you've seen in those countries is very poor people who don't have bank accounts, but everybody in those countries has a cellphone, or at least has access to one. There's one in a village, or a family, or something.

So what you've had in these very poor countries is essentially a payment system that is more sophisticated than what we have in North America. That's because when you buy something from somebody, you go to a store, you take your cellphone and you put it next to the store owner's cellphone. There's a program—or to use the economic jargon, there's a platform—on both of these cellphones. You push a few buttons and the money goes from one person's account that they've put onto the cellphone previously, so you don't have to walk around with cash. You load up your cellphone with some money and then it goes into the shopkeeper's account, so your account goes down and the shopkeeper's account goes up. This is in Kenya, this is in China. They are doing the same kinds of things.

So essentially what you have is that nobody has plastic; nobody has a bank account. You have the emergence of a brand-new, highly innovative competitor for the plastic credit cards from cellphones.

Will this happen in North America? Absolutely. The question is not if; it's when.

● (1040)

The Co-Chair (Hon. Michael Chong): Thank you, Mr. Scholnick.

Thank you, Mr. Menzies, for those questions.

Mr. Mulcair.

[*Translation*]

Mr. Thomas Mulcair: Thank you, Mr. Chairman.

I'd like to quickly respond to my colleague and friend Mr. Dechert by saying that the example I gave was that of a professional. In most provinces, including Quebec, professionals, for the most part, cannot incorporate. So, the example given was that of a person using his or her own personal card. The same thing would apply when a person buys RRSPs with points. Again, it is a tax advantage that is granted and a net loss for the economy in general.

I would like to give Mr. Scholnick and Mr. Ware an opportunity to speak because I did not get an opportunity to ask them a question earlier on.

[*English*]

We'll do it in the language of Shakespeare instead.

I want you to tell me where the $2 came from to give to my lady with her shopping cart. There seems to be a little bit of what we'd say in French *pensée magique* here. We have our two ladies in the Scotiabank ad walking out with their shopping carts. One of them is boasting that she just made two bucks off her credit card. I suggest to you that they both paid a buck in more expensive groceries. But maybe you can set me straight and tell me where that money came from.

Mr. Scholnick.

Prof. Barry Scholnick: I believe the answer is actually quite simple: the money came from the interchange fee that the retailer pays. What you have is a completely predictable outcome that economic arguments would lead to, based on the notion of a platform. It's based on the notion of a two-sided model. If you recall, I gave you examples of Google, the Yellow Pages, or the mall, where one side is subsidized, usually the shopper, and the other side pays, usually the provider. So what you—

Mr. Thomas Mulcair: Right. We understand each other, Mr. Scholnick, that if you say the $2 has been the interchange fee paid by the retailer, he passes that on in the form of more expensive groceries.

Prof. Barry Scholnick: Sometimes, if he can. But sometimes he can't, and it depends on the market situation of each retailer.

Mr. Thomas Mulcair: But where does it come from? The two bucks didn't fall from the air.

Prof. Barry Scholnick: If the retailer is in a competitive market and can't pass on the retail fee, that cuts into his profit. If the retailer has monopoly power, in the way economists describe it, then he can pass it on and it comes from the consumer.

Mr. Thomas Mulcair: Mr. Ware, do you want to take a kick at this one?

Prof. Roger Ware: Yes. I agree with my colleague Jack Carr, actually. The answer is that cash is a high-cost form of payment, so the consumer who pays cash pays $2 more for the good, as it should be, because he—or she, rather—is using a costly form of payment.

Mr. Thomas Mulcair: So you have a study that you've modelled that shows there's a 2% increased cost for paying cash. You can prove that to me. My name is Thomas. I like having stuff proven to me.

Prof. Roger Ware: No, I cannot, but I'm a believer in competition. I don't have a study, but you're talking about—

Mr. Thomas Mulcair: We're not here for wishful thinking about what we believe in. I want you to prove to me that the cost is there. Do you have a study? Have you worked on this?

Prof. Roger Ware: We look at prices. One of the things economists do is believe in competitive markets. Prices will move to costs.

Mr. Thomas Mulcair: Politicians talk about what they believe; I want you to prove it to me. You just said to me that paying with cash is so expensive for the merchant, oh me, oh my, and the other one's getting $2 back because she was kind enough to pay with a credit card, but you can't prove it to me.

Prof. Roger Ware: See, I would turn this around to you and say that in every single market we see in our economy, which we believe to be competitive, we would believe that prices correspond to costs. So why would you not believe that in this case?

● (1045)

Mr. Thomas Mulcair: But you still can't prove it. You don't have a study. You don't have a validated economic study that proves what you've just said, that the cash is costing them at least 2% more.

Prof. Roger Ware: I cannot cite one for you, no.

Mr. Thomas Mulcair: Okay, thanks. That's what I thought.

The Co-Chair (Hon. Michael Chong): Thank you.

Mr. Mulcair, do you have any further questions?

Mr. Thomas Mulcair: Mr. Scholnick wants to have another shot.

Prof. Barry Scholnick: One addition to my point is that, very interestingly, a few months ago the European Union, in a major anti-trust case against MasterCard on this identical issue, resolved the issue precisely in the way that Mr. Mulcair is discussing. The European Union decided that the interchange fee should be related to the extra cost of carrying cash. That was the test the European courts put in place. They've done the studies and they've figured out a number—I don't know what the number is—and that has become the interchange fee in Europe.

Mr. Thomas Mulcair: Since we can ask you such a thing, perhaps you could provide to the *greffier* of the committee the study in question from Europe and we'll all be able to get a copy of it.

The Co-Chair (Hon. Michael Chong): Yes, Mr. Scholnick, if you could provide the clerk of the committee, at some future date, with the reference to that study or a copy of the study, it would be appreciated.

Mr. Lee, and then Mr. Carr.

Prof. Ian Lee: I just want to answer Mr. Mulcair's question very directly. He said, “Where's the study?” AEI-Brookings Institute, 2006, Washington, D.C., an empirical study showing cash is more expensive than any other payment instrument. I presented it on my slides.

Mr. Thomas Mulcair: What's the percentage?

Prof. Ian Lee: It's on the slides.

Mr. Thomas Mulcair: What's the percentage?

Prof. Ian Lee: I didn't memorize it. It's on my slides.

The Co-Chair (Hon. Michael Chong): Thank you, Mr. Lee. Thank you, Mr. Mulcair. We can get a copy of that study from the clerk and provide it to members of the committee.

Mr. Carr.

Voices: [*Inaudible—Editor*]

The Co-Chair (Hon. Michael Chong): Order. Mr. Carr has the floor.

Prof. Jack Carr: I have two points. One is that the interchange fee should not be related to costs. The second thing is economists do studies, empirical work, and we look to see what happens. We know we have a system. If your argument were correct and cash were cheaper and it was more expensive to use credit cards, we should find—because there's nothing stopping merchants—merchants saying, “You're coming with a credit card and it's costing me more; I'm going to give a discount for cash.” The fact that we don't see it is proof—it's not proof, but it goes towards validating the proposition that it must be more expensive. If it weren't more expensive, what you would do is simply give a discount.

Now, it's not true for all transactions. Different retailers may have different costs of cash and credit card, and some retailers may say, “We're not going to accept credit cards”, as Costco does. It has a very efficient model and it works. For other retailers, that doesn't work. So what you find is, let the system compete. If cash is dominant, it will; if credit cards are dominant, they will.

Mr. Thomas Mulcair: In ending, just to say that—

The Co-Chair (Hon. Michael Chong): Thank you, Mr. Carr. Thank you, Mr. Mulcair.

We're going to go to Mr. Van Kesteren now.

Mr. Dave Van Kesteren (Chatham-Kent—Essex, CPC): Thank you, Mr. Chair.

I'm going to be splitting my time with one of my colleagues. I'm going to fire off three things.

First, just a statement. I appreciate what you said about cash, Mr. Carr. I think you also need to include cheques, and I'm not trying to correct your presentation. I remember being in business and waiting until the end of the month and seeing if that cheque was going to bounce.

Second, I've asked for a study. I appreciate what you've just done for Mr. Mulcair. I wonder if there is a study, and I've asked a number of other witnesses to follow consumer spending with consumer card use. In other words, is there a study that proves or disproves that as credit card use increases the spending increases as well, so there's a net benefit for the merchant as well?

Third, and finally—you don't need to answer this right now—there's been some talk about the credit card and how it has led to increased usage and possibly some problems with increased usage. Is the role of government to interfere with consumer habits? Aside from possibly making it mandatory to send a pair of scissors with every credit card, is it the government's role to correct or guard against bad behaviour and credit card use? I'll just open that up.

The Co-Chair (Hon. Michael Chong): Go ahead, Mr. Carr.

Prof. Jack Carr: Let me take one part of your question. You asked is there a study that shows that credit card use has increased as consumption has increased. There is a study, and that study was quoted in the Visa presentation. It's the Global Insight and Visa Canada study—*The Benefits of Electronic Payments in the Canadian Economy.*

What that study shows, and it does a statistical analysis, is it looks at what's happened to the growth of credit cards and the growth in the economy. It's not an easy matter, but if the argument is correct that credit cards are more efficient—it takes less cost to make these transactions than other forms—it saves on resources. Before we had anything, we had barter, which was very efficient. People spent all their time in exchange and none of the time in production. If you can spend less time exchanging and buying goods, you have more productive time for producing. The argument is that since credit cards are more efficient in making exchange, they free up resources for production, and output is higher. That's what the Global Insight study shows.

From there, it's an easy step that with higher output, consumption is higher. The biggest factor affecting consumer spending is output and income in the economy. That's where the link is, and that's the study you have to go to.

● (1050)

The Co-Chair (Hon. Michael Chong): Thank you, Mr. Carr.

We're going to go to Mr. Lake. We have two minutes left.

Go ahead, Mr. Van Kesteren.

Mr. Dave Van Kesteren: Nobody has addressed yet if it's the role of government to interfere with consumer spending habits. Should there be regulations?

The Co-Chair (Hon. Michael Chong): Go ahead, Mr. Scholnick.

Prof. Barry Scholnick: I think there's some role for government in terms of financial education and financial literacy. I think we know that financial literacy among most average people is very low. People make poor decisions because they have a lack of education on financial issues. So there's a key role for government.

I think there's another role for government in terms of transparency. When you get your monthly statement, it should be clear. You should be told if you don't pay off your account or you pay your minimum balance, it will take so many months or years to eventually get out of debt. All these transparency issues are the role of government.

However, beyond that, I think it's very hard for government to tell people what to do with their own money and their own credit cards.

The Co-Chair (Hon. Michael Chong): Thank you, Mr. Scholnick.

We're going to go to Mr. Lake now. He has a few questions.

Mr. Mike Lake (Edmonton—Mill Woods—Beaumont, CPC): I get a little bit concerned when I hear people asking for price regulation. Could you explain what would happen if we had a cap of a maximum interest rate on credit cards? What effect would that have on maybe cutting people off who might otherwise be able to get a credit card but couldn't? What other unforeseen consequences could there be to that kind of price regulation?

Prof. Jack Carr : Is this a cap on interest rates you're talking about?

Mr. Mike Lake: Yes, capping interest rates.

Prof. Jack Carr: It's usury laws. A long, long time ago, I wrote a paper, which never got published, on usury regulation. There's a huge amount of government regulation on interest rates, and it goes back to the Bible prohibiting any interest rates; it's in Deuteronomy, if you want to know where the original quote comes from.

Voices: Oh, oh!

Prof. Jack Carr: But if you look at the history of this, banks never got involved very much in consumer lending. Consumers used to borrow from sales finance contracts at very, very high interest rates. Credit cards were a way, even though we think of them as high-cost—but you have to look at the risk, the size, and the costs—of providing a line of credit to consumers, and at a lower cost than any other method for these particular consumers.

If the government comes in and regulates the interest rate, we know what happens when they put a cap on it. The demand for the loans will go up and the supply of loans will go down, and banks will have to ration. There will be people who will be squeezed out, who won't be able to borrow at all, and that can't be helpful.

So you're not helping anybody to say, okay, you're not going to pay these high rates; it's these low rates, but guess what, a large number of you won't be able to get these low rates because financial institutions will not be adequately compensated for the risks they take at that low rate. You'll just be pushing them out of the credit market.

The Co-Chair (Hon. Michael Chong): Thank you, Mr. Carr.

Mr. McKay.

Hon. John McKay (Scarborough—Guildwood, Lib.): I thank Professor Carr for that biblical reference. Possibly one of the recommendations of the committee should be that we have a year of Jubilee.

Prof. Jack Carr: Yes. That's another interesting example.

Hon. John McKay: It's another interesting example of how to deal with debt.

The problem here is that this system has become incredibly Byzantine. It takes an incredible amount of time just to follow all of the transactions, etc. The issue is that at the tail end or the front end of the system there is a load of rewards points, bells, whistles, etc., which have effectively distorted the system.

Professor Lee rightly analyzed the Australian system. There, they tried to do something. When you only try to do one thing in isolation, naturally the credit card companies react and either load up fees or do something else. That's the lesson to be learned in Australia: either you do it all or you do nothing.

Professor Lee, you seem to be driving to a "do nothing" argument; other than, well, we need more education and we need to be more literate and all that sort of good stuff, it's really "don't do anything". But don't we really want a credit card system that looks a little bit more like the interchange debit card system, which basically runs on a cost or a cost-plus system and doesn't have a whole whack of bells, whistles, rewards, incentives, etc.? Then you'll actually get the best of both worlds. I'd be interested in your comment on that.

● (1055)

Prof. Ian Lee: This is a feature of the modern economy, this complexity of the product lines. On what you were saying about all the bells and whistles, there are over 200 credit cards. It reminds me of walking into a shoe store; it's just an amazing blizzard of options. Or buying a car.... In most consumer markets today, they're much more sophisticated than back in the fifties, when you went into a store and they had two of everything. You had two choices. If you go back even further, Henry Ford said you can have it in any colour you want as long as it's black—

Hon. John McKay: But aren't we talking about a blizzard of money here, and do I really need a blizzard of money in order to pay for all of those various shoes in the shoe store?

The Co-Chair (Hon. Michael Chong): Okay. We're going to hear from Mr. Lee, and then from Mr. Ware.

Prof. Ian Lee: But I'm answering your question. I said this is a feature of consumer product markets across the economy. That's number one.

Number two, the consumer makes that choice.

A voice: No, they don't.

Prof. Ian Lee: Those credit cards or those shoes or whatever that are not going to meet the needs of consumers will wither and die. Surely it's not the role of the legislators to determine, or to pick, winners and losers among product lines. So if you've shifted from picking winners and losers among credit card companies to saying let's pick winners and losers among product lines, that's called business strategy, and that's the role of the entrepreneur, not of Parliament.

The Co-Chair (Hon. Michael Chong): Thank you, Mr. Lee.

Mr. Ware, you had a comment in response.

Prof. Roger Ware: Yes.

Well, the answer to your question is no, we would not want a system like the Interac system for credit cards. It may have fortuitously worked well for Interac back in the mid-nineties, but as I said earlier, we need to change it now.

Just really to echo what Professor Lee said, this is a differentiated product market in which there is a wide variety of products available to consumers. Those are there because consumers demand a wide variety of products. That's a good thing, not a bad thing. It's a good thing.

Hon. John McKay: I do wonder whether consumers demand these things or they're told to want these things. Therein lies an incredible difference. When I'm paying for a product, I'm just paying for a product. I didn't even realize—and I think I'm a sophisticated consumer; I had no idea of all the costs to the merchants and all the things that were loaded on to my credit card, much to my surprise, which ultimately cost the system a great deal more money.

So I agree with your point that the debit card system worked well, and probably the consent order; its best before date has arrived, but you don't want to necessarily throw the baby out with the bathwater. I look at the Bank of Canada costs on a per transaction basis, and on a debit basis it's about two-thirds. The processing fee costs about two-thirds of the overall cost. On a credit card, the processing fee represents about 90% of the overall cost.

Why wouldn't I want a credit system to look a lot more like a debit system, so that ultimately I have more money in my pocket?

The Co-Chair (Hon. Michael Chong): Thank you, Mr. McKay.

Please be brief, Mr. Ware, and then we're going to—

Prof. Roger Ware: Well, of course, there's nothing to stop you using a debit card to make your purchase, in which case you'll get that.

On your point about variety, you know we could argue that consumers all want to wear white shirts, and if we just made them wear white shirts, then they'd all be better off, but that's not the kind of society we live in, and hopefully we don't want to live there.

● (1100)

The Co-Chair (Hon. Michael Chong): Thank you, Mr. Ware.

Now we're going to give Mr. Rajotte, my co-chair, a chance to ask one or two questions before we adjourn for the day.

The Co-Chair (Mr. James Rajotte (Edmonton—Leduc, CPC)): Thank you very much, Mr. Chairman. Thank you all for coming in and making your presentations in this very lively discussion.

Mr. Scholnick, on page 4 you talk about the economics of two-sided markets, and you talk about a balancing act, where a platform loses value if either side withdraws. The objectives of the platform are to make as much money but still keep both sides using your platform, retailers and consumers. But is it a fair two-sided market there, because retailers in my view.... You say there's an option of cash or cheque, but in reality, as Mr. Lee pointed out, that's a decreasing option, if it is still an option today, because as a consumer, if I go into a store and they tell me I can't use a credit card, the reality is I'm going to frequent that store less and less.

Can you address whether this platform is fair to retailers? One side is much stronger than the other in this two-sided market.

Prof. Barry Scholnick: This is the very nature of two-sided markets. This is why two-sided markets are so different from what we see in the economic textbooks that we all teach.

You possibly are right, and I think the remedy, the way to fix this problem, is through the competition authorities, which is why I was pleased to see that the Canadian Competition Bureau is looking at this under the very specific element of the Canadian Competition Act, which is the abuse of dominant power, abuse of a dominant position. You correctly say that Visa and MasterCard have a dominant position. They're different from the shopping mall. If they're abusing that—and we don't know if this is the case yet—then the competition authorities and the Competition Tribunal should penalize them. But if they're not abusing it, then I would suggest this is the nature of two-sided markets, in that because you've built up your platform, because your platform is valuable, because people have to use the platform, some people will be subsidized and the other side will not be subsidized.

The Co-Chair (Mr. James Rajotte): I wish I had more time, but thank you very much for clearing that up.

The Co-Chair (Hon. Michael Chong): Thank you, Mr. Rajotte.

Before we adjourn, I just want to ask Mr. Lee if there are any more recent studies that were conducted after October 2004. One of the members of the committee asked me if there were any studies more recent than the AEI-Brookings working paper that was published in October 2004, in light of the fact that some card products have been introduced since that date.

Prof. Ian Lee: I've copied the Brookings study, which by the way was in 2006, and I have also copied onto the clerk's laptop the Bank of Canada 2008 study of merchant attitudes towards the relative cost of payments. I have also copied the Federal Reserve study of the central bank of Australia. So I've copied several studies for the committee.

The Co-Chair (Hon. Michael Chong): Thank you.

Perhaps we could clarify with the clerk after the meeting the exact dates of those studies.

Thank you to all the witnesses for attending. We appreciate your advice and your comments.

The meeting is adjourned.

Published under the authority of the Speaker of the House of Commons

Publié en conformité de l'autorité du Président de la Chambre des communes

Also available on the Parliament of Canada Web Site at the following address:
Aussi disponible sur le site Web du Parlement du Canada à l’adresse suivante :
http://www.parl.gc.ca
