Sanders-Ocasio-Cortez plan to cap credit card interest rates will backfire on consumers

Credit card interest rates can creep up on American consumers, but the answer to this problem isn't politicians promising to lower rates.

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Senator Bernie Sanders and Rep. Alexandria Ocasio-Cortez recently introduced their first joint piece of legislation — a proposal to impose a national interest-rate ceiling of 15% on all consumer credit products, from credit cards to payday loans. They promise that capping interest rates on credit cards and other consumer loans will benefit working families, but history indicates the benefit will come at the expense of everyone else — especially the half of all households who pay their balances every month.

The ubiquity of general purpose credit cards (such as Visa and MasterCard) for middle-class Americans is a relatively recent phenomenon. In 1970 only 16% of American households had general purpose credit cards, and only two percent of low-income households, primarily because restrictive interest-rate ceilings made it too risky to lend to all but the wealthiest Americans. Credit card issuers offset their inability to charge a market rate of interest by imposing annual fees or bundling credit cards with other products such as checking accounts (which carried higher monthly fees in states with more restrictive usury ceilings). But consumers hate annual fees, especially those who do not carry balances but were forced to subsidize those who do. Moreover, annual fees were highly regressive, as every consumer paid the same annual card fee regardless of whether they charged $3,000 or $30,000 a year. Annual fees also stifled competition as most consumers were willing to pay to carry only one card, at most.

America's complicated credit history

Retailers, such as department and appliance stores, had a more effective way to evade interest rate ceilings — they simply marked-up the price of the goods they sold to offset losses from their credit operations. One study from the era found the price of goods typically financed (such as major appliances) was 3% to 8% higher in states with more restrictive usury ceilings than the identical products in neighboring states. Consumers, especially higher-risk ones, obtained much more of their credit from retailers (instead of banks) in states with stricter usury ceilings. The need for retailers to provide financing for customers provided a major competitive advantage to huge department store chains (such as Sears and JC Penney) that could better bear the cost and risk of extensive credit departments over smaller competitors. Meanwhile, cash customers paid inflated retail prices to subsidize below-cost financing to credit purchasers.

Those who needed credit for non-durable goods, such as medical bills or a car repair, were forced to rely on providers such as high-cost personal finance company loans or pawn shops, which were often regulated by a different set of regulations or could avoid interest-rate ceilings by reducing the price offered for pawned goods.

We need lenders of last resort

Sanders and Ocasio-Cortez's proposal would effectively outlaw these lenders of last resort too. History warns, however, that abolishing the supply of credit does not eliminate the demand. In states where usury ceilings eliminated alternative lenders, generations of desperate working-class families turned to illegal loan sharks that preyed on the urban working class for most of the Twentieth Century. So severe and chronic was the multi-billion dollar loan-sharking racket that eventually even consumer advocates and liberal politicians such as Robert Kennedy pleaded with state legislatures to raise or eliminate their interest rate ceilings so hard up families had legal choices.

The Supreme Court's 1978 decision in "Marquette National Bank v. First of Omaha Services Corp.effectively deregulated credit card interest rates. Writing for a unanimous Supreme Court, liberal icon Justice William Brennan held that the applicable usury ceiling for banks chartered under federal law (which includes virtually every large credit card issuer), would be the issuing bank's state law, instead of the customer's. Credit card operations quickly migrated to states such as South Dakota, which allows rates on most credit cards to be set by markets instead of politics.

Legislation would invite legbreakers

The effective elimination of usury ceilings transformed the credit card market, as many previously-excluded consumers gained access to credit cards for the first time. By 1998, almost 75% of American households had general purpose cards. Annual fees have largely disappeared on credit cards. Competition for customers is fierce: Most card-owning households have multiple cards and they say that it is easy to switch cards if dissatisfied. Rewards are now commonplace, even among subprime cardholders, but likely would disappear under the Sanders-AOC proposal. Breaking the link between department stores and credit provision has enabled small merchants to compete with big ones on equal footing. And, of course, widespread access to credit cards was the necessary condition for the e-commerce revolution.

Senator Sanders and Representative Ocasio-Cortez promise lower interest rates for those who revolve balances on their credit cards. They ignore the reality that those who are lucky enough to still have credit cards if their proposal was adopted would be forced to subsidize those who carry balances through higher annual fees, fewer rewards, more pawn shops, and even the return of legbreakers. Perhaps someday Washington will consider a "Protection from Politicians Who Promise to Help Us" Act.

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