
Free-Market Justice Is in the Cards

BY J. H. HUEBERT

Nearly everyone takes it for granted that if government did not protect consumers from fraud, no such protection would be provided. The free market, however, protects consumers in countless ways, all without any government intervention. In fact, it does so more efficiently and effectively than the government can.

One of the most impressive examples of free-market justice involves something that might be in your pocket right now: your credit card. Through voluntary contractual arrangements—motivated by nothing more than a desire for customers and profit—credit-card companies provide an entirely private means of recourse when a merchant wrongs a customer.

Visa and MasterCard, the two most popular credit cards, are brand names jointly used by banks that have gotten together to issue the cards. Every bank that belongs to the Visa or MasterCard association can also open accounts for merchants who wish to accept the cards. The very existence of these organizations is a testament to the free market's ability to overcome the challenges of coordination to deliver to consumers the products they desire.

To understand how credit-card companies provide justice for consumers, we must first understand how an ordinary credit-card transaction works. Suppose Jones buys a camera from a merchant for \$500 using his Visa card, which was issued to him by Bank A. The merchant, however, has a Visa merchant account through Bank B. How is the payment accomplished?

Today, it is most common for stores to have electronic terminals for processing credit-card transactions. So Jones would swipe his card through this terminal. When he does this, the terminal first determines that it

is a Visa card rather than one of the other cards the merchant accepts. Then information about Jones's card goes to the computers of the bank with which the merchant has his Visa merchant account, Bank B. Bank B's computers contact Visa's central computer, which looks up Jones in its system and sees that his card was issued by Bank A. Visa then transmits an inquiry to Bank A to see if Jones has sufficient credit to buy the camera. The answer to that inquiry will come back to Visa, which will pass it back to Bank B, which in turn will pass it back to the merchant. If the answer is no, because Jones does not have enough credit, he will not be able to make the purchase. If the answer is yes, he will sign the familiar slip accepting the charge to his credit card, and that will complete the sale. Today, this entire process may take as little as two seconds.

The merchant, of course, still needs to be paid. He transmits the request for payment to Bank B. That request goes through the same channels as the authorization request. The cardholder's bank pays the merchant's bank, which then pays the merchant. At that point, it is up to the cardholder's bank to collect the amount due from the cardholder.

The banks make money from this process through the "merchant discount" they charge. This is often around 2 percent. In the case of Visa, for example, 1.4 percent goes to the card issuer. This is called an "interchange fee" and is set by Visa. The remainder, 0.6 percent, goes to the merchant's bank.

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When Things Go Wrong: The Government Solution

What if Jones's camera is something other than advertised? What if he was promised one kind of lens and got a different, inferior one, or the camera just doesn't work? Because of the free market's incentive to satisfy customers, most stores would allow Jones to make an exchange or get his money back. But surely there are some disreputable merchants who would not do this for Jones, since they are out to make a quick buck with no concern for their long-term reputations. Thus sometimes a consumer must appeal to a third party for redress.

If Jones had paid cash for the camera, his only recourse would be to go to a government court, probably his local small-claims court. Filing a lawsuit, even in a small-claims court, is costly, cumbersome, and time-consuming. In most jurisdictions, one must pay a fee just to file a suit. To have a reasonable chance of success, a defrauded consumer probably would need to hire a lawyer. If the seller he is suing is large and sophisticated, it might have superior lawyers who are experienced in fighting consumer lawsuits, perhaps often killing them quickly through procedural maneuvers and the like. Alternatively, the merchant might not show up to defend himself against small claims and the plaintiff would win. But then he would have to collect a judgment, which might be difficult to impossible. A large percentage of small-claims-court judgments are never collected at all, perhaps because the defendant is insolvent or located prohibitively far away, making the lawsuit a waste of the plaintiff's time and effort, as well as a waste of taxpayer dollars.

The cash-paying customer with a complaint may also have problems with evidence. What if he has lost his receipt? The case might come down to his word against the seller's.

The customer who pays with cash or a money order is in even worse shape if he buys something from someone located in another country. If a customer located in the United States sues a foreign merchant in an American court, it may not have jurisdiction or the ability to enforce a judgment against the seller even if the customer wins.

If the customer tries to sue in the foreign country, he will almost certainly have to be present there and will have to hire a foreign lawyer. Even if this were not a major obstacle, the foreign country's legal system might be significantly less accessible than that of the United States, even for locals, especially in developing countries. Then, of course, there are the further potential difficulties of language barriers and court bias against foreign parties, among other things. As a result, the high costs make almost any consumer-fraud lawsuit across international borders prohibitively expensive.

Chargebacks: The Private Alternative

So government does provide consumers with nominal, if often useless, opportunities to pursue redress. On the other hand, credit-card companies know that no one wants to go to small-claims court. More important, they know that the presence of their logos on merchants' doors and in advertisements is interpreted as a seal of approval, even if not intended as such. It is not good for Visa and the other brands to appear to be associated with crooks or anything else unpleasant to consumers.

Thus the card companies have created their own system for pleasing consumers who have problems with credit transactions. This is called the chargeback. Under the card companies' chargeback procedures, a consumer can inform his card issuer of his dispute and the issuer will then help him settle things.

To begin chargeback proceedings, a cardholder files a complaint for free, using a form provided by the card company. (It is often included on the back of each month's billing statement.) On receiving the complaint, the card company may ask the cardholder for documentation to support his claim. If he appears to have a legitimate grievance, the bank will then initiate a chargeback against the merchant's bank—that is, the cardholder's bank will take the money back from the merchant's bank. The merchant's bank has no choice but to allow this because each bank in each card system has contractually agreed to these recourse procedures.

The merchant will then be given an opportunity to produce evidence on his behalf. If his bank believes the transaction was valid, it will initiate a chargeback against the cardholder's bank—that is, it will take the money back from the cardholder's bank. If the dispute continues

and cannot be resolved between the two banks, it will be arbitrated by the credit-card organization.

Are chargebacks better for consumers than the government's dispute-resolution system? There is no guarantee that any system of justice will reach the correct result. But consider the following advantages of the private system.

Under the chargeback regime, the procedure for the aggrieved consumer is much simpler and better. When a consumer wants to file a complaint, his card issuer is available to assist him by phone, usually toll-free, 24 hours a day, 365 days a year. Once he files his complaint, he does not need to hire a lawyer—his bank uses its own resources to go to bat for him and puts him on an equal footing with the merchant, regardless of how wealthy or powerful the merchant is.

The bank will be able to reach and process chargebacks against any of its merchants anywhere in the world—except in a few countries, such as France, whose governments have abolished chargebacks by law to protect merchants.

Given these advantages, and the disadvantages of the government system, what credit-card holder

wouldn't prefer the nongovernmental alternative?

This goes to show that the common belief that only government can provide justice in consumer-fraud cases is false. Indeed, as we have seen, government is an inferior provider of justice in this realm.

Subject to Court Review?

It might be argued that the relationships among the banks, merchants, and cardholders are governed by contracts, and those contracts, even if they contain private-arbitration clauses, are ultimately subject to review in government courts. That is true, but not really important.

What primarily holds these arrangements together is not the threat of government intervention but the

desire of all involved to do business with one another. Cardholders want to pay with plastic, and merchants want to accept it. Thus both cardholders and merchants agree to the terms set forth by their banks and the card associations. This would not change even if government stayed out of disputes; that is, if a card association could not rely on government to enforce a member bank's agreement to comply with chargeback procedures, that would not spell the end of credit cards or doom the chargeback process.

To minimize risks of noncompliance in the absence of government enforcement, the parties involved

might have to spend more to acquire knowledge about the trustworthiness of their contracting partners. For example, more resources might have to be used to investigate merchants before allowing them to accept credit cards. A well-developed credit-bureau system would be ready to assist.

Under such circumstances the banks would have the right incentives to spend the optimal amount of resources to determine who will keep their promises. This is in contrast with government, which has no incentive to spend an optimal amount—even if it could determine that amount—in

resolving contract cases when things go wrong.

Today over 18 million merchants accept Visa, and MasterCard runs a close second. In the United States, credit-card acceptance in certain market segments, such as department stores, supermarkets, and gas stations, is nearly universal. On the Internet, of course, it is by far the most commonly used form of payment.

Technology has opened up countless new opportunities for trade for individuals in every part of the world. The credit-card chargeback regime advances those prospects by letting consumers know that they will have an opportunity for redress if they are wronged, and that they will not be forced to rely on outdated, inefficient, ineffective, and costly government courts.



Credit-card companies have created their own system for pleasing consumers who have problems with transactions involving credit cards. This is called the *chargeback*.
