



Junk Fees Are Just Bureaucratic Junk Food

Any parent will tell you that forcing children to eat their spinach is no way to win a household popularity contest. Children don't care about the long-term benefits of eating healthy food when the alternative is the short-term thrill of sugary treats. Much to their children's chagrin, parents impose rules, like limiting the quantity of treats and making their receipt contingent upon finishing a healthy meal. Good behavior must be encouraged with appropriate incentives.

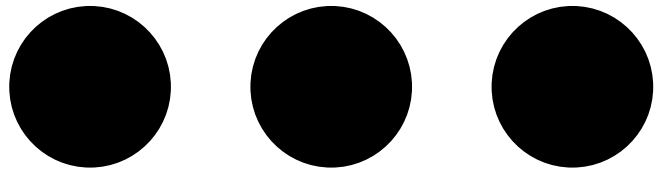
Fortunately for parents, their authority does not derive from the consent of the governed. But imagine for a moment if it did. Children could appeal unpopular parental decisions to some higher authority that needs their strong support. Not only would it be hard to maintain the "no treats before dinner" rule, but there could also be a complete banishment of spinach — maybe even all veggies. Kids would cheer the results, but their future adult selves will come to regret it.

This is functionally what's happening at the Consumer Financial Protection Bureau (CFPB). The CFPB has proposed limiting banking and credit card late fees to \$8 per overdraft as part of a larger effort to eliminate the misleadingly labeled "junk fees." In this case the "junk fee" is the \$25 to \$35 fee credit card issuers impose for overdue payments. Credit card companies collect an estimated \$14 billion in late fees annually.

According to CFPB director Rohit Chopra, "junk fees make it harder for us to choose the best product or service because the true cost is hidden," hence the \$8 cap, which consumers who have been hit with the fees will cheer. However, what people want and what is good for them is not necessarily the same.

Consumers like paying late fees even less than children like eating spinach. In a utopian world, no one would ever pay late fees. Everyone would only spend the money they have — no one would be late on their payments in the first place. In the real world, however, people often want, and sometimes need, to make purchases on credit. And unfortunately, those same people are sometimes late in making their minimum credit-card payments. Ironically, the reason people can easily borrow money on credit cards and pay late is because of late fees. No less importantly, the reason why people try to be timely in repaying is also because of burdensome late fees.

The ability to levy appropriately stiff late fees is an important part of the overall consumer credit system. Placing arbitrary limits on such fees might prove popular with consumers today but will also



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leave these same consumers worse off tomorrow. Companies use heavy fees to discourage late payments. While the actual fee provides some amount of income, its chief function is to lower and offset the risks of lending. Companies would prefer that payments arrive on time rather than having to collect late fees.

Proper risk management doesn't just benefit financial institutions. Individuals considered risky are still able to access credit because of contractual terms like late fees. Lighten the fees and delayed payments will increase, making lending money riskier for institutions. When that happens, the only tools left to manage risk will be higher interest rates — which means higher costs even for responsible borrowers — or outright denials of low-income credit card applicants.

Rob Nichols, president of the American Bankers Association, similarly predicts that “credit card issuers will be forced to adjust to the new risks by reducing credit lines, tightening standards for new accounts and raising APRs for all consumers, including the millions who pay on time.”

Late fees are already capped at a maximum \$30 for a first late payment and \$41 for any subsequent violations. Although the current rules impose what are essentially price controls, a large enough difference in degree becomes a difference in kind. The much stricter \$8 cap can be expected to have much more pronounced negative consequences, especially for low-income consumers. Economic history is replete with examples of price controls leading to shortages. In this case, putting a ceiling on the price card issuers can charge for late payments will inflict most of its damage on low-income consumers who can least afford to lose credit.

The Biden administration, wanting a cheap political win, is counting on consumers being overjoyed with the sugary treat of lower late fees. But we see again that wanting something does not mean that it's good for you. Preventing or severely limiting the ability of financial institutions to assess appropriate late fees will hurt consumers who can least afford it.

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