Credit Information Reporting, Social Accountability, and Consumer Opportunity[1]

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SOCIAL ACCOUNTABILITY MECHANISMS

"Gossip" has a bad name. But everyone gossips to some extent, because everyone chats with coworkers, neighbors, and friends, often about other people. Gossiping can be a crucial part of performing one's job, and an important source of information on goods and services, employment opportunities, neighborhood problems, and other daily concerns.

In fact, gossip is vital to society because it serves the indispensable function of creating accountability. Usually, when people interact, if one party fails to meet his or her obligations the other party is the only person who sees the failure. Reporting it helps to form a reputation on the chiseler and creates pressures against chiseling. No one wants a reputation as a chiseler, and an excellent way to avoid acquiring one is not to chisel.

Civilized society depends on accountability mechanisms, including gossip. No one denies that many individuals will meet their obligations even if no social mechanisms exert accountability; people do have a conscience and a sense of honor. But an external system of accountability encourages people to cultivate the practices and habits necessary to develop internal accountability. Moreover, the extent of our obligations is often unclear to us. Knowledge of what is appropriate in any particular situation depends on the signals sent to us by accountability mechanisms when the spirit is willing but the mind is uncertain which actions would be regarded as good.

And, of course, social-accountability mechanisms not only police our own scruples, they protect us against predation, because there will always be people who act irresponsibly and fail in their obligations.

Society has many social-accountability mechanisms. The media is one. Scholarly peer review is another. Both the criminal and civil justice systems are accountability mechanisms. All of these work to reward good behavior and punish bad, and to function effectively they must obtain information about who did what to whom, when, and why. They ask questions, assess the validity of responses, and judge the credibility of character. All accountability mechanisms collide with privacy, with the human desire to keep things secret, especially things that, in the common phrase, "are not to one's credit."

The credit-reporting agency (or credit bureau) must be seen within this framework, because it is an exceedingly important social-accountability mechanism. Lenders, employers, landlords, and insurers are interested in making opportunities available to consumers (in their role of prospective credit users, employees, tenants, and insurance policyholders), but only if they can obtain information on trustworthiness. These groups pay credit bureaus for information about consumers, especially information about whether they have met past credit obligations.

In America, the credit-reporting business is dominated by three large companies: Equifax, Experian, and TransUnion. They work through more than 500 local offices and contracted affiliates. Through their local offices and affiliates, they receive information from virtually every creditor. Hence, the flow of information is two-way.

As a by-product of this primary function, credit bureaus use the information generated to assemble marketing lists for companies and organizations which need to identify consumers likely to be interested in their products. The gamut of purchasers ranges from L.L. Bean to the National Braille Press to the Children's Television Workshop (Sesame Street Magazine) to the Sierra Club.

Both these functions—credit reporting and the facilitation of targeted marketing—are now under attack in the name of "privacy."

POLICY ISSUES CONCERNING CREDIT-REPORTING AGENCIES

Consumers in general know very little about how credit reporting works, and tend to be suspicious. The range of information included on credit reports is smaller than many suppose. Credit reports usually include only the following kinds of information:

- consumer's name, address, Social Security number, place of employment, and spouse's name;
- open credit lines, outstanding credit balances, credit limits, history of timeliness of payments, and amount of last payment;
- bankruptcies, liens, and public judgments against the consumer.

Reports do not include information about life-style, religion, political affiliation, driving records, medical history, or other dimensions of the consumer's life, dimensions that might well be known even to a casual acquaintance.

Nor does the information circulate freely. The Fair Credit Reporting Act (FCRA), passed in 1970 and amended in 1996, specifies that credit reports may be purchased only by those with a "permissible purpose," notably creditors, employers, landlords, and insurers. Terms of strict confidentiality surround the use of reports by these parties. One need not fear that neighbors are reading one's credit report.

About 10,000 creditors supply information to credit bureaus each month. The bureaus virtually always report that information faithfully. In rare cases, faithful reporting is erroneous reporting because creditors occasionally supply inaccurate information. The creditor may have failed to record or update actual payments or delinquencies by consumers. The errors of others surface in reports assembled by the bureaus, who bear the brunt of complaints. Errors in the broadest sense occur for many reasons: public records are faulty, consumers neglect to have their mail forwarded, consumers misplace bills, outgoing mail fails to find its way to the mail box, mail is improperly delivered, mail is improperly forwarded, and so on.

When a consumer disputes information in a credit report, a verification process begins. The dispute is usually submitted in writing. The verification process flows from the consumer to the bureau to the creditor and back again. Consumers with valid complaints have good cause to feel some frustration, but one must realize that credit bureaus do not know beforehand whether a complaint is valid or spurious. If they revised their records to satisfy every complaint received by phone, scam artists would claim to be the victim of errors. The 1996 Amendments to the FCRA require the bureau to verify disputed information within 30 days or delete it from the records. Barry Connelly, president of Associated Credit Bureaus, claims that in most cases disputes are verified or resolved within two weeks. When adverse information is verified and the consumer feels that there is more to the story, he may enter a brief statement to be included in the record (usually limited to 100 words). Also, when a consumer disputes information with the creditor, the creditor must report the account information as "in dispute."

Some consumer activists, journalists, and public officials charge that credit bureaus violate people's privacy, report false or incomplete information, share information with inappropriate parties, and fail to respond to consumer inquiries and disputes. Critics claim to be protecting consumers from losing out on opportunities such as mortgages or car loans.

Partly as a result of these charges, credit-reporting services are restricted by state and federal laws. Restrictions on the books and on the agenda include measures to do the following:

- impose penalties or assign liability to credit bureaus for errors in reports;
- require credit bureaus to notify or get permission from consumers before using information about the consumer;
- specify rigid procedures for credit-bureau operation, including how long information may be retained on reports, how credit reports are to be written, who may use the reports, how consumers are to be notified of credit decisions, and how consumer inquiries and disputes are to be handled;

- provide consumers with their credit reports at no charge or reduced prices;
- require credit bureaus to respond to consumer inquiries within a specified time period or face penalties;
- create government bureaucracies to police the credit bureaus and formulate new regulations on their operations.

The lengthy 1996 Amendments to the FCRA included many of these restrictions. Credit reporting has been made into a major public issue only in the last 10 years, but now the issue is here to stay. Critics continually seek to add further restrictions, and lawsuits and policy initiatives concerning credit bureaus are multitudinous and can be expected to continue.

The critics only dimly recognize that credit bureaus are important social-accountability mechanisms. Any infringement on privacy or propagation of erroneous information ought to be compared to that of other social-accountability mechanisms: gossip, the media, the courtroom. In such a comparison, the credit bureau may serve as a paragon of reliability and discreetness. It conveys only the most pertinent information to only the most relevant parties in a highly standardized, impersonal, and professional manner.

An understanding of accountability illuminates the far-reaching benefits made possible by credit bureaus. Credit bureaus make opportunity—in the form of credit, employment, housing, and insurance—more available and more affordable to everyone in society. These things cannot exist without accountability in society. Because institutions such as credit bureaus are part of the foundation of civil society, the policy debate over their operation is of paramount importance.

Once we understand the importance of credit bureaus as social-accountability mechanisms, we are more inclined to regard the criticisms leveled against them as unreasonable and, often, fundamentally impossible. In particular, some critics want to require not only greater accuracy, but agreement from the consumer before certain bits of information are included. Accountability mechanisms can always be honed to greater precision, but a tension must exist between making information more accurate and making its availability dependent on the consent of its subject. Because people have an incentive to suppress the bad, the two goals conflict. If laws guaranteed complete privacy, the freedom to warn others about those who fail to meet their obligations would be destroyed. (And imagine a parent's reaction if victims in his or her neighborhood had to respect the privacy of a babysitter who molested children.) People would be inauspiciously silenced. The need for accountability mechanisms in credit is underscored by the startling increase in filings for personal bankruptcy, which tripled between 1986 and 1997.

ORIGINS AND HISTORY OF CREDIT BUREAUS

Before credit bureaus existed, creditors, merchants, and landlords relied on word-of-mouth, letters of reference, and other forms of gossip to assess the trustworthiness of a consumer. Everyone had to be his own credit bureau, gathering, interpreting, formatting, storing, retrieving, and transmitting information. Creditors and others could monitor information on regular customers and local parties, but their information, and, hence, their confidence were limited. In consequence, they made opportunities available only to those who were known. Prior to World War II, few retailers sold on credit, and those that did confined it to well-known customers.

Creditors could exchange information with each other, sharing lists of names known to be poor credit risks. But crisscrossing systems are inefficient. Far better is a centralized agency that serves as a hub for all creditors and merchants, collecting information from all, dispensing it to all, and reducing redundancy, inconsistency, and variability in communication.

Commercial credit reporting on the reliability of merchants and companies in meeting obligations to wholesalers and suppliers developed as a private business during the 19th century, culminating in the now-dominant firm of Dun & Bradstreet. Consumer credit reporting developed primarily in the form of community cooperative or nonprofit associations operated for the benefit of the users. The reason for the difference is the more personal nature of consumer credit information. Retailers fear that customers will be offended by questions, and unsettled by the thought of an investigation. In dealing with consumer information, a cooperative organization, such as a merchants' association, arouses less suspicion and resentment than does a for-profit business. Furthermore, at its inception a credit bureau may face a significant collective-action problem in getting businesses to participate, and cooperative appeals may be an especially effective method of securing cooperation.

Only after decades of development by cooperative organizations was consumer credit reporting ready to operate on a commercial, for-profit basis. During the 1950s, 60s, and 70s, with the boost of new technologies in communications, big companies entered the field by buying up the operations of regional organizations, eventually integrating them into a highly uniform, nationwide service.

Although most credit bureaus today operate on a for-profit basis, their fundamental function has not changed: providing information so that two parties, who may be perfect strangers, can trust each other enough to engage in mutually advantageous exchange.

TWO TYPES OF ERRORS

Imposing on credit bureaus a liability to pay large damages to consumers for inaccurate, adverse information in credit reports could well result in information that is less complete and less accurate, and reduce the extent to which credit is available to deserving consumers.

If a bureau becomes overly averse to the risk that information is incorrect, it will err on the side of avoiding entry of any detrimental information, even that which is accurate. Users of the reports would soon learn that they were getting watered-down information, and would have less confidence in transacting with strangers. They would make opportunity less available even for consumers who had used credit responsibly. Restrictions on free speech would eliminate opportunity for the trustworthy and the untrustworthy alike.

When they focus exclusively on one type of error—the risk of inaccurate information—critics are thinking asymmetrically. If bureaus are made to pay heavy damages to consumers harmed by the inclusion of inaccurate information, why shouldn't bureaus also be made to pay damages to businesses harmed by the exclusion of accurate information? Yet if *this* liability were imposed, then credit bureaus would be in a no-win situation, which would strangle the goose that lays the golden eggs.

Another asymmetry in the complaints against credit bureaus exists: Given that credit bureaus make possible much of the opportunity that consumers enjoy, why should consumers be able to sue credit bureaus when reports have errors, but not be required to pay rewards to credit bureaus when reports do not have errors? Critics are asserting, in essence, that consumers are entitled to have their credit report maintained without serious inaccuracies, but, symmetrically, one could assert that credit bureaus are entitled to rewards from consumers when reports are accurate. Such paradoxes of the entitlement mentality recommend that we reject entitlement in favor of the cogent alternative: obligations by contract.

CONSUMER OPPORTUNITY DEPENDS ON ACCOUNTABILITY MECHANISMS

Restrictions on free speech and free commerce have many consequences. In *Economics in One Lesson*, Henry Hazlitt writes that those like the consumer activists "are presenting half-truths. They are speaking only of the immediate effect of a proposed policy or its effect upon a single group." The great challenge is to supplement and correct "the half-truth with the other half." But to consider all the consequences of a proposed policy, Hazlitt says, "often requires a long, complicated, and dull chain of reasoning." Only by seeing consequences that are unintended and nonobvious can policymakers really serve consumers. The art of economics is elucidating these consequences.[2]

Consumer activists propose safeguards to protect the consumer from unfair outcomes resulting from erroneous information. But they overlook the influence of the proposed safeguards on the system as a whole. If the cost of credit reports rises, then fewer will be requested, and more customers will be granted or denied credit based on arbitrary factors, such as appearance or zip code. The deteriorated quality of credit reports in general will reduce credit opportunities in the future.

The reduced utility of credit reports will have other unfortunate effects. If obtaining credit becomes less dependent on consumers' credit history, consumers will become less vigilant in meeting their obligations, knowing that doing so will not cost them future opportunity. As the social-accountability mechanism becomes less effective, consumers in general will become less trustworthy.

As we trace the effects further, we find that the harm caused by "protection" widens. If credit reports become more expensive, more costly to handle, and less informative, businesses that have been giving credit might stop doing so. Furthermore, in rare cases it will happen that the business shuts down operations altogether and no longer provides goods and services to consumers or jobs to workers.

There are yet other ways that hardship befalls consumers because of restrictions. If credit reports are more expensive or less informative, then businesses that trust consumers will be operating at higher cost and suffering more losses from delinquencies, defaults, and other failures to meet obligations. Increases in the cost of doing business translate into higher prices for consumers. When consumers get credit—which will be less often—they will pay higher interest rates. When they get housing, they will pay higher rental rates. When they get employment, they will receive lower salaries. The injury to each consumer may be small, but that small injury must be multiplied by the great number of consumers who are affected. And increased business costs may affect the prices of any of the items a creditor sells.

In advocating restrictions, consumer activists do not attempt to demonstrate that their proposed restrictions will do more good than harm. They tend not even to acknowledge harm. The social-accountability mechanisms that serve consumers and businesses alike depend on layers of institutions and practices. Consumer activists pretend that those institutions and practices will go on keenly serving consumers even when hamstrung by restrictions. They take for granted many of the blessings of the modern economy.

Nor do they seem to understand that the system already has substantial incentives to create accurate information. It is not to the advantage of a business that a trustworthy consumer be wrongly denied credit. And it is not to the advantage of the credit bureau to furnish reports that contain errors. All parties have clear incentives to make the information correct. Do not believe the drumbeat of animadversion on this point that issues from activist organizations and is replayed in the press.[3]

PRIVACY AND THE ISSUE OF MARKETING LISTS

Many companies, especially those conducting business on the Internet, now accumulate information about their customers and sell marketing lists to other businesses. Activists have long attacked credit bureaus for making personal information available to marketers, who then annoy the consumer with "junk mail."

The activists, citing practice in Europe, seek to restrict free speech in the name of privacy. In European Union countries, consumers have to "opt in" in order to be included in list-making services. Instead of the European opt-in rule, credit bureaus in America practice an "opt-out" rule, whereby consumers can exclude themselves from mailing lists generated by a credit bureau by notifying the bureau of their wish not to be included. Since there are three major bureaus, three notices suffice. (For full instructions on opting out of mailing lists and telemarketing, go to the Direct Marketing Association's web site at http://www.the-dma.org/consumers/consumerassistance.html.)

Thus, activists play upon the paranoia of consumers and voters, who know little about the system's actual workings. The proposed restrictions would hurt consumers, as they do in Europe.

What does L.L. Bean or the Sierra Club really find out about consumers from credit bureaus? Practically nothing. Such marketers specify consumer characteristics and request a list of individuals who match those characteristics, or some combination of them. For example, the characteristics may be number of credit cards, zip code of residence, or positive payment history. The characteristics may be refined and detailed, but the marketer never sees credit reports.

Indeed, the marketer usually does not see even the list. The credit bureau is not eager to share its stock-in-trade, and it guards the exclusivity of the information. Most lists go to a third-party fulfillment house, which sends the marketer's catalogs out to consumers on the list. In those cases, only the fulfillment house sees the list. The credit bureau seeds each list with decoy names and addresses, and if catalogs other than those associated with the original order show up at the decoy address, the credit bureau knows that the fulfillment house cheated on the contract. The fulfillment house is then subject to penalties or loss of repeat business from the credit bureau—notice how reputational mechanisms cascade throughout the system to assure promise-keeping and discreetness. The suppleness of contract allows men and women in commerce and industry to overcome problems in ways far more creative than dreamt of by interventionists.

It is annoying to find our mailboxes stuffed with advertisements and catalogs. But opt-in requirements (à la Europe) would impose a burden on consumers who gain from commercial information. Because opting in would call for added time, attention, and effort, many consumers would miss opportunities they would like to have, opportunities that would improve their condition. Indeed, it is the prescreening services of credit bureaus that make the credit-card industry so competitive.

While everyone has a certain disdain for junk mail in the abstract, catalogs are actually a great boon, helping consumers discover and acquire products without leaving home. They are especially valuable to the disabled, the elderly, parents with families, and people without cars. In 1991, the Consumers Union noted that the ability to narrow the market reduces costs, and has spawned some 10,000 specialty catalogs, selling everything from apples to automobiles to waders to wine.[4]

Given the narrow range of information used in compiling mailing lists, concern over "privacy" is mainly a red herring. But even if infringements were serious, we should be wary of the privacy activists. They are peddling restrictions that do not provide coherent principles and which upset other vital principles. The activists often suggest that consumer information should be treated as the property of the consumer. But people cannot rightly be said to own information about themselves. Pure information is not a form of property and hence cannot be owned. As Solveig Singleton says,

> [I]f someone buys a lawn mower from Sears…two parties engage in the transaction—the customer and Sears. Why should the information about the sale belong only to the customer and not to Sears as well? If the customer were to complain about the transaction to Consumer Reports, he would not have to ask Sears's permission. Why cannot Sears boast of the transaction to its creditors?[5]

Information exists only in as much as a thinking human mind reacts to certain external events. External events may be influenced by legal rules, but it is incoherent to think of information itself as someone's property, which they should somehow be able to dole out, as they dole out their money. The same incoherence characterizes the concept of "privacy" as the term is used in these debates, where it seems to mean a right to have others not have information about you.

Legal rules may govern the external events that go into the creation and conveying of information. But before restricting freedom with arbitrary regulations, let us ask whether freedom of contract might not provide an effective framework for dealing with privacy issues, one that is far superior to regulatory requirements. People can form contracts that specifically forbid their trading partners to reconvey information. Illegitimately reconveying the information would then be a breach of contract—a failure to live up to a promise—not a misuse of someone's property. Contract provides a coherent principle. A system based on freedom of contract would accommodate consumers' preferences about receiving junk mail and learning of products.

If activists Europeanize information services in America, they will also work to Europeanize consumption opportunities and living standards. American consumers are much-better served by the safeguarding and revitalizing of the American customs of free speech, free enterprise, and opportunity, along with a tort system that responds to errors arising from negligence or contract breach.

CONCLUSION

In a vast society like the United States, our opportunities depend crucially on our ability to persuade strangers to trust us. But this will happen only if we give them reasons. Credit bureaus respond to this need by collecting and collating information. They create the instant reputation necessary to convince strangers that we can do business, that social accountability is working.

The secondary function of helping marketers reach efficiently the subsets of consumers likely to be interested in their offerings is also an opportunity-enhancing activity. Without the benefits of niche marketing, each of us would have difficulty discovering all the options available to us.

The activists are using privacy as a red herring. They are promoting slogans and agendas that do not rest on coherent principles of law and that do not reflect people's legitimate expectations. They seem to remain rather ignorant of the affirmative uses of information collection. They seem to dislike free speech, free enterprise, and freedom of contract. Their interventionist agenda kills opportunity and breeds litigation. To the extent they succeed, consumer opportunity and well-being will be reduced.

Notes

[1] A longer version of this paper can be found at http://lsb.scu.edu/~dklein.

[2] Henry Hazlitt, *Economics in One Lesson* (San Francisco: Laissez Faire Books, 1996), p. 6.

[3] For a detailed analysis of this issue see Daniel B. Klein & Jason Richner, "In Defense of the Credit Bureau," *Cato Journal*, vol. 12 (1992), pp. 393-412, and Solveig Singleton, "Privacy as Censorship: A Skeptical View of Proposals to Regulate Privacy in the Private Sector," *Cato Institute Policy Analysis*, no. 295, January 22, 1998.

[4] *Consumer Reports* (1991), p. 643.

[5] Singleton, p. 15.