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# State Automobile Franchise Laws: Public or Private Interests?

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## Introduction

Nearly every aspect of automobile manufacturing, distribution, and use are regulated at either the state and federal levels (and sometimes both). These laws cover environmental concerns, safety features, licensing, lemon laws, and many other aspects of the auto business. For instance, every state has legislation governing the retail sales of new automobiles, with most states precluding the direct ownership of retail outlets by auto manufacturers. When you buy a new car, you buy it from an independently-owned, franchised dealer.

While these state laws requiring independent retail dealerships have been on the books for decades, they have come under intense scrutiny in recent years, mainly due to lobbying efforts by Tesla Motors.[1] Tesla wants to operate its own retail outlets, as it does in California, but is prohibited by law in several states from doing so. The company's efforts to alter these laws, at least to provide a limited exception to Tesla, have met with success in some states (e.g., New Jersey), but have been rebuffed in others (e.g., Texas).[2]

This heightened focus on auto franchise laws has caught the attention of the Federal Trade Commission ("FTC"), which is now conducting an investigation, and held a public workshop in January 2016, to "explore competition and related issues in the context of state regulation of motor vehicle distribution and to promote more informed analysis of how the regulations affect businesses and consumers."[3] Although the FTC's review of the industry covers a variety of issues, the Agency appears particularly focused on the question of whether the "the complex system of automobile sales" benefits consumers.[4] Such questions arise because of differences of opinion on the purpose of such state franchise laws. On the one hand, some parties believe these laws are needed to balance the bargaining power between individual consumers and powerful car manufacturers by inserting independent intermediaries that create competition on price and servicing. On the other hand, some observers cast the local franchise laws as little more than a protectionist scheme, insulating auto dealers from competition and increasing car prices.

In this POLICY PERSPECTIVE, we consider the implications of this contrast in perspectives on the evaluation of state auto franchise laws. First, we address the claim that state auto franchise laws are protectionist and thus serve primarily *private* rather than *public* interests by comparing the evidence presented to support this view to the theoretical predictions from economic theory and what we know about car markets. We conclude that the evidence presented does not provide much support for a protectionist slant on these laws. For instance, the private interest theory requires that car prices be higher under the current system than in the absence of such laws, but it is well-established that price competition over new cars is intense, leading to razor thin margins for new car retailers.

Second, we evaluate the competing claim that the independent dealer serves an important role for consumers. Using a Nash bargaining model that is motivated by accepted facts about auto sales, we find that there are consumer benefits of state laws requiring independent sales of automobiles—primarily, lower prices for consumers. Indeed, we find that a consumer-motivation for these laws has good support and appears to be most consistent with the available evidence.

**Public or Private Interest Legislation**

Most state auto franchise laws prohibit manufacturers from directly selling cars to the public (among other things). As a result, these laws are often seen as protection for independent dealers. Indeed, in an immediate sense, these laws are protectionist and are intended to be, but such a characterization says nothing about whether such laws advance the public interest. Does the particular market design created by such laws better serve consumers? We will turn to that question later, but for now, let's consider whether the evidence supports the assertion that the current franchise laws are protectionism in the more conventional sense—protection of dealers from competition, thereby leading to higher prices. This view of franchise laws is quite common,[5] yet a review of the evidence typically presented by opponents of the laws does not support the claimed protectionist motivation for them.

The *Public Interest Theory* of legislation or regulation holds that the government is a neutral arbiter that serves to correct some inefficient or inequitable market practices, thereby benefiting consumers and potentially sellers as well.[6] Most, if not all, of the arguments supporting auto franchise laws—or all laws—are based on this public-interest view of government intervention. It's admittedly a rosy take on the U.S. political systems, and economists are generally cynical regarding such claims.

In contrast, the *Private Interest Theory* holds that regulations serve the interests of particular groups, including the regulated firms or their large, sophisticated customers.[7] These groups compete for special interest legislation or regulation in order to shifts rents from other groups to themselves. Occupational licensing is perhaps the most cited and studied instances of private interest legislation. As a general matter, the economics profession's distaste for occupational licensing is supported by time-honed arguments and a well-developed empirical literature. Sadly, the theory often describes the real world of government activity with great accuracy.

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Accordingly, bringing auto franchising laws under the umbrella of private interest legislation is admittedly a natural progression and the path of least resistance for the economist, especially in light of the profession's strong bias against government restrictions on competitive entry.[8] Nevertheless, an application of generalized arguments against *particular* laws governing *particular* industries carries risk.

In its depiction of auto franchising laws, the FTC staff labels such laws as an "an anomaly within the larger economy,"[9] but the fact is that the automobile industry *is itself* an anomaly within the larger economy. In that light, the FTC's evaluation of auto franchising laws—laws governing the nearly $570 billion new-car market where the product has an average price of just over $34,000—cannot be merely a routine classroom exercise.[10] The character of the auto industry, as well as a respect for the federalist principles upon which this country is founded, deserves thoughtful economic and legal analyses specific to the industry.[11]

*A Heavily Regulated Industry*

The franchise laws are not the only intervention by federal and state legislators into the auto industry. The automobile industry is not lightly-regulated by any means and perhaps for sound reasons; cars are essential to American living, but they are also expensive, complex, and dangerous. State and federal laws on the automobile industry cover environmental concerns, financing practices, licensing, insurance, consumer safety and so forth.

Some of these laws clearly aim to help consumers. For instance, all fifty states and the federal government have lemon laws which protect consumers from autos that fail to meet acceptable standards of quality and performance.[12] Such laws—both federal and state—suggest legislators believe private incentives alone, even in the relatively competitive auto industry, may not be perfectly aligned with the interest of consumers, a fact inconsistent with the FTC staff's assertion that the manufacturer will act in a way "it believes will be the most responsive to consumers."[13] To the contrary, as self-interested economic actors, auto manufacturers will act in ways to maximize profits, not consumer or social welfare.[14] And, like the character Bill Babowski in the movie *Tin Men*, consumers want to pay nothing for a car, but that's not realistic. Market outcomes reflect a balance of the interests of buyers and sellers, and that balance is influenced by whatever rules and regulations influence the transaction.

*Does the Evidence Support the Claim?*

A critical step in analyzing the motives for auto franchise laws is to review the evidence on their effects. From what limited documents are available that summarize the FTC staff's examination of the industry, it appears that the protectionist slant on the laws is based primarily on a thirty-year old FTC staff report claiming that these laws raise prices.[15] This study has been criticized and superseded by subsequent studies, but the FTC staff ignores the more recent evidence.[16] A published evidence by Professor Michael Waldon (2006), for example, finds no price effect of franchise laws.[17]

Also, FTC staff points to a series of dated empirical studies on gasoline prices.[18] The gasoline market is very different from the auto market, so it's not clear what a study about gas prices has to do with "the complex system of automobile sales."[19] The Agency's staff offers no answers. FTC staff has also pointed to a direct-sales experiment by GM in Brazil as a proof of concept.[20] Apparently unbeknownst to the staff, that experiment was an abysmal failure and was eventually shut down.[21] Thus, even at first glance, the evidence appears weak.

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As noted above, the evidence most cited by the Commission's staff is the thirty-year old FTC study on price effects of local dealer franchise laws (*"1986 FTC Study"*).[22] This study was released in 1986 using data from 1978, which alone says much about the pertinence of the evidence for modern times. Let's look at the details of that study to determine its relevance for the present analysis of state franchise laws.

The study's author posits two theories that would cause franchise laws to drive prices higher. First, the laws are imagined to create market power for dealers, thereby leading to higher prices. Second, the laws are hypothesized to limit entry and thus reduce the number of dealers, which raises cost and thus prices. This price effect is based on the assumption that a dealer's costs rise in the quantity of cars sold.[23] These are the only two explanations provided in the *1986 FTC Study* to support the claim that auto franchise laws increase car prices: (1) market power; (2) higher costs. There is, of course, always a third possibility—the empirical model or the data is defective.

While this study is often used to support the claim that franchise laws create market power by limiting competition, the *1986 FTC Study* actually concludes "the market power theory is rejected."[24] Hence, it must be the second theory—the cost theory—that explains higher prices. (That is, if either theory is valid.) Yet, this high-cost theory is difficult to square with the actual experience in auto retailing.

By most expert accounts, there are *too many*—not *too few*—dealerships, especially for the traditionally domestically branded cars.[25] Nor is there any evidence to support the argument that dealer costs rise in the number of cars sold, at least not in the relevant output range of the average car dealer. Given the high fixed costs of operating a new car dealer, it is more likely the case that there are scale economies in car sales.

In any case, the private interest theory implies that the franchise laws give independent dealerships increased market power, not higher costs. In all, the evidence of both intense competition among dealers and the lack of market power[26] doesn't square up with the private interest theory or the use of the dated FTC study to critique franchise laws.

*The Facts Don't Match*

Another blow to the application of the private interest label to state auto franchise laws is that these laws have been around since the 1930's and exist today in all fifty states.[27] The argument that every state legislature has imposed laws that raise price and/or reduce efficiency in auto retailing, and have done so decade-after-decade, requires a little more explanation than some extraneous evidence about gas prices and failed projects in Brazil. As noted by Nobel Laureate Gary Becker, efficiency has an inherent advantage over inefficiency, and the persistence of significant inefficiency over an extended time scale is an anomaly that must be explained to be believed.[28]

Using the private interest theory, it is very difficult to explain the fact that every state has a franchise law. Michigan, the nation's dominant economy for auto manufacturing, passed an auto franchise law in 1981.[29] At the time, motor vehicle manufacturing accounted for 10% of Michigan's economy.[30] Even today, Michigan continues to employ more persons in auto manufacturing than any other state in the nation, accounting for nearly 40% of direct automobile manufacturing jobs.[31] In fact, for every one job in auto retailing, there are over five auto manufacturing jobs. In terms of economic power that might prove influential over a state legislature, auto manufacturing would easily dominate auto retailing in Michigan. Consequently, the application of the private interest theory to franchise laws would almost certainly predict Michigan would not have a franchise law. Yet, since 1981 Michigan has had a state franchise law for auto retailing, and continues to have one today.

It is likewise difficult to rationalize the claim that state auto franchise laws raise prices for automobiles—by 7% if we take the *1986 FTC Study* as gospel. Cars are a very expensive capital good purchased by virtually every household in a state.[32] An auto is the second largest purchase a consumer makes, trailing only housing.[33] Private interest legislation acts as an implicit tax, and it seems the last way to gather votes is to tax heavily a very large purchase made by most of your constituents.[34] In fact, in Alabama, the state charges a sales tax on car purchases (2%) half that of other goods (4%).[35] Moreover, new automobiles are sold at scant profit margins, a fact even the FTC economists concede.[36]

If the state franchise laws are viewed merely as crude rent-seeking, then their persistence for decades in all states is difficult to rationalize using the economic theory of private interest regulation. The empirical evidence on car prices and dealer margins on new cars also contradicts the private interest theory.

**Independent Dealerships and the Consumer**

While the FTC staff appears mostly opposed to franchise laws, the staff is at least open to the possibility that the "reliance on independent dealers [achieves] the best outcome for [] the consuming public."[37] We now to turn to an economic analysis that provides a mechanism by which state auto franchise laws favor consumers.[38]

Automobiles are complicated, expensive durable goods that are able to provide the expected stream of transportation services only when they are combined with a maintenance/recall program sufficient and appropriate to the task. Thus, from the buyer's point-of-view, purchasing and using an automobile necessarily involves two related, but logically separate, dimensions. Although somewhat of an over-simplification, the net benefits obtained by the consumer in using the automobile depend on both the price paid for the vehicle (i.e., the initial price) and the degree of support (i.e., maintenance and repair), this latter factor being obtained over time after the initial acquisition. Here we propose to demonstrate that this fact may offer an explanation for the persistence of auto franchise laws that does not rely on the simple and ultimately unsatisfactory claim that such laws are merely inefficient pandering to special interests as FTC staff appears to believe.

Ultimately, the existence of independent dealerships introduces a persistent intermediary between buyers (whose demands for new cars and car services are lumpy and disconnected in time) and manufacturers. These dealerships sell both new cars and provide maintenance and recall services for consumers continuously.[39] In the absence of such independent franchised dealers, buyers would be, in effect, bargaining directly with the manufacturer, of which the direct sales retailer would be merely a creature. Viewed in this light, the function of independent dealerships can be seen as affecting an aggregation, or "bundling" of the separate relevant elements—the new car price and service support—over which the individual buyer bargains. Unlike the retail purchaser, the dealer engages in continuous and ongoing transactions with the manufacturer, and this continuity is interpreted as changing the nature of the implied bargain between the retail customer and the manufacturer. We explore this basic idea in what follows.

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It must be admitted at the outset that any granular description of transactions between car buyers, independent retailers, and manufacturers of automobiles, is likely to be very complicated and, in consequence, not terribly useful. However, we are fortunate in the present circumstance to have several widely-accepted "stylized facts" which help focus the analysis. Specifically, these facts are: (1) the margins earned by auto retailers on new car sales are extremely low, and much of the profit in car retailing comes from servicing, and the like;[40] and (2) consumers are relatively more satisfied with the prices they pay for new cars than they are with the levels of services they receive from dealers after the sale.[41] These stylized facts, if accepted, are evidently a consequence of the structure of automobile retailing, which is characterized by independent franchised dealerships. These facts, though, can be shown to be a logical consequence of the role of the independent retailer as a "bundler" of the relevant issues in the negotiations between car buyers and (ultimately) the manufacturer.

In the simplest terms, the analysis proceeds as follows. Manufacturers produce cars, and also service components for their cars, and consumers want to buy both cars and service support (e.g., warranty service and safety recalls). The typical consumer derives benefits from both dimensions: consumers want low car prices and also lavish service support. In contrast, the manufacturer, with profit as its objective, wants to charge high prices and provide minimal costly service, so the usual tension between buyer and seller is evident. In the usual fashion, we may imagine the buyer and seller negotiating ("bargaining") over these dimensions, resulting in an intermediate outcome.

If the dealer is merely an instrument of the manufacturer (thus having identical preferences), then the dealer's function is purely technical: dealerships provide retail delivery and service as part of the manufacturer. When the potential buyer bargains with the dealer, she is merely bargaining with the manufacturer. This is important: if there are no independent dealers, then car purchases can be thought of as bargains over price and service between a consumer and the manufacturer. The consumer rarely buys cars, and her acquisition of cars and car repair/warranty services are discrete and random in time.

This story is clearly inadequate, though, when the dealer is itself an independent intermediary. The independent dealer, by definition, does not have preferences that are identical to the manufacturer. The dealer, instead, sells cars acquired from the manufacturer to a succession of local buyers, simultaneously providing warranty services and so on. From the dealer's perspective, the issues of car prices and service support are not sequentially presented, as they are to the retail buyer, but instead occur simultaneously among perhaps thousands of separate buyers. The dealer's profits will be determined, *inter alia*, by wholesale prices for cars and reimbursement for warranty repairs and the like.

What, though, could be the practical implications of this difference? When dealers are independent of the manufacturer, then they do not act as pure instruments of the manufacturer. At the same time, however, they are not servants of consumers: dealers act to maximize their profits, just like everybody else. How, then, could the existence of independent dealers benefit consumers, and what form would such benefits take?

Although one could imagine many ways in which independent dealers could alter the nature of car purchase bargaining, one obvious effect is suggested by the discussion above: independent dealers are persistent actors in the car market who are not manufacturers. The relations between the franchisees and the manufacturers are inclusive, persistent, and ongoing. Thus, the presence of such independent retailers implies that the terms (express or implied) of transactions are resolved "simultaneously" as implicit parts of the franchise agreements. This conceptualization has an interesting consequence that leads to conclusions consistent with the stylized facts about new car retailing detailed above.

To see this, consider a simple model of bargaining between two parties (a car buyer and a manufacturer), in which the presence of an independent intermediary is seen as allowing the customer to indirectly bargain with the manufacturer (through the dealer) over both aspects of the car purchase simultaneously. This simple modification of the strategic scenario has interesting implications.

*Bargaining Model*

Let there be a buyer (B) and a manufacturer (M) that must bargain over two aspects of a potential car purchase, the price $p$ and the level of service support $s$ (e.g., warranty, recall, etc.) The payoffs to both parties are given by:

$$B_p = (1-p),\ M_p = p\,, \tag{1}$$

$$B_s = s^{\alpha}\,,\ \ M_s = (1-s)\,. \tag{2}$$

Expression (1) shows the payoffs for price; Expression (2) the payoffs for service. We assume the parameter α is less than one, an assumption that makes the buyer's payoff function concave with respect to future service support on the vehicle. This curvature in the buyer's payoff represents the notion that the consumers derive a lot of utility from basic service that keeps the vehicle performing its fundamental functions (e.g., the transmission), but the marginal utility declines as less essential service is performed (e.g., eliminating every single noise or rattle). Further, this curvature also captures a notion of risk aversion relative to the manufacturer who views a dollar spent on service equivalent to a dollar collected on the sale.

Let us consider first the case in which the two dimensions are resolved separately. Presuming the two parties engage in Nash bargaining over the two issues separately, we obtain:

$$p^* = 1/2\,, \tag{3}$$

$$s^* = \frac{\alpha}{1+\alpha}\,. \tag{4}$$

In contrast, suppose we envision a joint bargain, where the issues are resolved simultaneously and the joint payoffs are the sum of the two issues:

$$B_j = (1-p) + s^{\alpha}\,, \tag{5}$$

$$M_j = p + (1-s)\,. \tag{6}$$

Here, the Nash outcomes would be:

$$p_j^* = \frac{1}{2}\left(1+\frac{1}{\alpha}\right)\alpha^{1/(1-\alpha)}\,, \tag{7}$$

$$s_j^* = \alpha^{1/(1-\alpha)}\,. \tag{8}$$

When we compare the outcomes and welfare of the parties under these two scenarios, we see that:

$$p_j^* < p^*\,; \tag{9}$$

$$s_j^* < s^*\,; \tag{10}$$

$$(B_p^* + B_s^*) < B_j^* = M_j^* < (M_p^* + M_s^*)\,. \tag{11}$$

From Expression (11) we see that from the manufacturer's point-of-view, the nature of consumer demand for services and the essentially "zero-sum" character of price negotiation implies that separate bargaining over price and service is more profitable (i.e., $M_j^* < M_p^* + M_s^*$). In contrast, the retail buyer benefits when these two aspects of the transaction are resolved "simultaneously" (i.e., $B_p^* + B_s^* < B_j^*$). The ability of an independent franchise dealer effectively to "bundle" these aspects of the transaction is valuable to consumers. Retail purchasers could not enforce this bundling on their own versus a manufacturer.

*Consistency with the Evidence*

Although somewhat abstract, this interpretation gains considerable support from our "stylized facts" listed above. First, the bundling leads to lower retail car prices for buyers (by Eq. 9). What we observe, of course, is retail prices for new cars that exhibit miniscule margins, a result that is consistent with the model's predictions. Simultaneously, though, service, for which the consumer's marginal benefit declines (i.e., dash rattles are not serious mechanical issues), is reduced compared to that obtained in independent bargaining; there's no lack of consumer complaints regarding repair work (or the lack thereof). Thus, the bundling of the bargains by the independent dealership makes consumers better off by potentially trading off some service for a lower initial price. Notably, survey evidence indicates the service quality provided by the dealerships remains quite good.[42]

Most importantly, though, and returning to our earlier discussion of the paradox implicit in viewing state auto franchise laws as a pure rent-extraction mechanism, consumers (i.e., citizens/voters of the states that promulgate these laws) benefit, on net, from the bundling of the issues of price and service coverage/support.[43] Although they may sacrifice some service, the very low price for the car up-front more than compensates for the reduction in support for less important service issues. States, then, would have an interest in franchise laws if, as seems probable, the existence of the franchisees favorably affects the bargaining between buyers and the manufacturer and keeps the initial price of the car very low.

*Consumers and Market Design*

Our analysis suggests an alternative take on the FTC staff's "principal observation [] that consumers are the ones best situated to choose for themselves both the cars they want to buy and how they want to buy them."[44] The way the market is designed effects how consumers are able to buy cars and service. As shown here, the manufacturer prefers separate negotiations for the car and the subsequent service whereas the consumer wants the two elements of the transaction bundled. Independent dealerships perform such bundling and are in a continual relationship with manufacturers through their franchise agreements. Thus, it is not true—as FTC staff asserts—that "the law should permit automobile manufacturers to choose their distribution method to be responsive to the desires of car buyers," because manufacturers do not respond solely to the desires of car buyers.[45] Manufacturers maximize their profits, and profits are higher when the bargains are separate.

Consumers, operating collectively through their legislatures, can alter the design of the market for auto distribution in a way that leads to a more consumer-friendly outcome. State franchise laws, therefore, can address "supportable public policy considerations,"[46] and not merely private interest legislation as the FTC's staff seems to believe.

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**Double Marginalization**

Economic theory tells us that an upstream firm (a manufacturer) wants its product to be sold in a highly-competitive downstream, retail market.[47] A competitive downstream ensures that the item is sold at a low price, thereby maximizing the demand (and profits) of the upstream firm. Alternately, if a downstream retailer has market power, then it will set a high retail price in order to earn an above-competitive profit for itself, which, in turn, reduces demand and profit upstream. For this reason, the upstream prefers not to have a "double margin" on its products. One argument against independent dealerships is double marginalization. This argument was made, for instance, by Professor Fiona Scott-Morton, a participant in the FTC's January 2016 workshop.[48] Evidence from auto retailing, however, does not support the conclusion that state auto franchise laws lead to double marginalization.

Double marginalization, as put forward by Professor Scott-Morton (among others), is a rather crude phenomenon. She envisions a market where auto manufacturers hand-off cars to an uncompetitive auto retailing sector and never look back. That's not how the car business works. As Blair and Lafontaine observe in THE ECONOMICS OF FRANCHISING, with respect to double marginalization, there is "more than one way to skin a cat," since there are contractual alternatives to vertical integration.[49] Manufacturers and dealerships operate under very complex contracts, and these long-term relationships provide many opportunities—sales quotas, discounts for high quantities, and so forth—to avoid double marginalization.[50] The evidence suggests the absence of double marginalization; profit margins on new automobiles are very low.

Moreover, Professor Scott-Morton states that "[i]f a manufacturer sells to independent [franchised dealers] then both it and consumers want lots of those dealers."[51] In fact, that's exactly what auto retailing looks like. No industry analysts have claimed that there are too few car dealers; both inter- and intra-brand competition are intense. In fact, with respect to intra-brand competition, experts widely agree that, if anything, there are too many retailers. Economist Patrick Rey observed that the problem of double marginalization is "important only when both the franchisor and the franchisees have significant market power—that is, if both inter-brand and intra-brand competition are weak."[52]

Professor Scott-Morton mischaracterized the roles of intra- and inter-brand competition in auto retailing. Intra-brand competition occurs between dealers of the same brand and, consequently, is focused largely on price. Inter-brand competition is softer in that the rivalry also occurs over styling, warranties, and so forth. Inter-brand competition is quite strong in automobile retailing, but when it comes to lowering price, intra-brand competition is king.

In 2015, the Phoenix Center released a study on the effects of inter- and intra-brand competition in the U.S. automobile market.[53] We found strong evidence that intra-brand competition drove down prices: the greater the geographic distance between two same-brand dealers, the higher prices were on the same models. Intra-brand competition was much stronger than inter-brand competition, at least in affecting prices.

***As FTC Chairwoman Edith Ramirez noted … the relevant question is "whether consumers benefit from [the state auto franchise system?]" Based on the analysis presented here, the answer may well be "Yes."***

Professor Scott-Morton also appears to believe that seeing higher prices when dealers are more distant is evidence of an unwarranted exercise of market power, but that's not really the case.[54] The cost structure of a car dealership has a large fixed cost component (e.g., showrooms, service bays, inventory, and so forth), and the margins on auto sales (and other services) must be sufficiently large to cover those fixed costs. In small markets, fewer cars are demanded and sold, and as a result dealerships are further apart so that sales are sufficient to cover cost. The higher price that results is required to cover the higher average fixed cost of a dealership in a small market. As observed in the seminal paper on market power and antitrust by Landes and Posner (1981),[55]

> When the deviation of price from marginal cost [] simply reflects certain fixed costs, there is no occasion for antitrust concern, even though the firm has market power in [terms of a markup of price over marginal cost.]

Indeed, profit maximization by firms under free entry will result in the same pattern between distances and prices even though profits are zero.[56]

Competition in the retail market for new automobiles is intense. That's the way the manufacturer wants it, and that's the way it is. As for whether the laws limit entry, the evidence presented at the FTC's January 2015 workshop suggests th manufacturers mostly have their way when they wish to increase the number of dealerships. And, experts agree, if anything, there are too many dealerships.[57]

**Conclusion**

Without dispute, the automobile market is one in which all levels of government have a keen interest. Federal and state laws address a wide range of issues covering the manufacturing, distribution, and use of the automobile. Many of these laws and regulations serve plausible public interest concerns, but the FTC is taking a close look at state laws requiring new cars be sold by independent franchised dealers. Such laws have been labeled by some analysts as anti-consumer, serving only to protect dealers from competition and raise prices.

As detailed in this PERSPECTIVE, the view that state auto franchise laws are protectionist is inconsistent with the evidence and theory used to support the claim. Moreover, an economic model of car and service sales shows that franchise laws, by introducing an intermediary between the individual consumer and the powerful manufacturer, serve valid public policy considerations and can be pro-consumer. In selling an automobile-service bundle, the independent dealership may have better incentives with respect to consumer desires than does the manufacturer.[58] As such, it is not unreasonable for state legislatures to choose a market design that best serves their constituents.

As FTC Chairwoman Edith Ramirez noted in her opening remarks at the FTC's January 2016 workshop, the relevant question is "whether consumers benefit from [the state auto franchise system?]"[59] Based on the analysis presented here, the answer may well be "*Yes*."

## NOTES:

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5 *See, e.g.*, D.A. Crane, *Tesla and the Car Dealers' Lobby*, REGULATION (Cato Institute Summer 2014) (available at: http://object.cato.org/sites/cato.org/files/serials/files/regulation/2014/7/regulation-v37n2-3.pdf) J. Ellig and J. Martinez, *State Franchise Law Carjacks Auto Buyers*, MERCATUS ON POLICY (January 2015) at p. 1 (available at: http://mercatus.org/publication/state-franchise-law-carjacks-auto-buyers) ("These state laws harm consumers by insulating dealers from competition and forestalling experimentation with new business models for auto retailing in the twenty-first century."); F. Lafontaine and M. Slade, *Exclusive Contracts and Vertical Restraints: Empirical Evidence and Public Policy*, Working Paper (September 2005) (available at: http://econ.sites.olt.ubc.ca/files/2013/05/pdf_paper_margaret-slade-exclusivecontracts-verticalrestraints.pdf); F. Lafontaine and F. Scott-Morton, *Markets: State Franchise Laws, Dealer Terminations, and the Auto Crisis*, 24 JOURNAL OF ECONOMIC PERSPECTIVES 233-50 (2010); March 26, 2014 Letter to Governor Chris Christie, International Center for Law and Economics (available at: http://www.laweconcenter.org/images/articles/tesla_letter_icle.pdf).

6 *See, e.g.*, A.C. Pigou, THE ECONOMICS OF WELFARE (1932); R.A. Posner, *Theories of Economic Regulation*, 5 BELL JOURNAL OF ECONOMICS AND MANAGEMENT SCIENCE 335-358 (1974).

7 G.J. Stigler and C. Friedland, *What Can Regulators Regulate? The Case of Electricity*, 5 JOURNAL OF LAW & ECONOMICS 1-16 (1962); S. Peltzman, *Toward a More General Theory of Regulation*, 19 JOURNAL OF LAW & ECONOMICS 211-240 (1976); G.S. Becker, *A Theory of Competition Among Interest Groups*, 98 QUARTERLY JOURNAL OF ECONOMICS 371-400 (1983); F.S. McChesney, *Rent Extraction and Interest-Group Organization in a Coasean Model of Regulation*, 20 JOURNAL OF LEGAL STUDIES 73-90 (1991).

8 We refer primarily to the arguments made by Professors Dennis Carlton, Dan Crane, and Fiona Scott Morton, as well as the FTC Staff letters to Rep. Paul D. Moriarity dated May 16, 2014 (available at: https://www.ftc.gov/system/files/documents/advocacy_documents/ftc-staff-comment-new-jersey-general-assembly-regarding-assembly-bills-2986-3096-3041-3216-which/140516nj-autoadvocacy.pdf) and to Rep. Michael Colona (New Jersey) dated May 15, 2014 (available at: https://www.ftc.gov/system/files/documents/advocacy_documents/ftc-staff-comment-missouri-house-representatives-regarding-house-bill-1124-which-would-expand/140515mo-autoadvocacy.pdf). The content of these two letters is very similar, so subsequent references are to the "Moriarity Letter."

9 Moriarity Letter, *id.*, at p. 4.

10 M. Spector, J. Bennett, and J. Stoll, *U.S. Car Sales Set Record in 2015*, WALL STREET JOURNAL (January 5, 2016) (available at: http://www.wsj.com/articles/u-s-car-sales-poised-for-their-best-month-ever-1451999939). For details on sales and other

## NOTES CONTINUED:

services, *see NADA Data 2014*, National Automobile Dealers Association (2014) (available at: https://www.nada.org/nadadata).

11 *See, e.g., New Motor Vehicle Board of California v. Orrin W. Fox Co.*, 439 U.S. 96, 107 (1978) ("California Legislature was empowered to subordinate the franchise rights of automobile manufacturers to the conflicting rights of their franchisees where necessary to prevent unfair or oppressive trade practices.")

12 https://www.carlemon.com/lemons.html; http://www.dmv.org/automotive-law/lemon-law.php.

13 Moriarity Letter, *supra* n. 8 at p. 4.

14 *See, e.g.*, D. Harwell, *America's Best-Selling Cars and Trucks are Built on Lies: The Rise of Fake Engine Noise*, WASHINGTON POST (January 21, 2015) (available at: https://www.washingtonpost.com/business/economy/americas-best-selling-cars-and-trucks-are-built-on-lies-the-rise-of-fake-engine-noise/2015/01/21/6db09a10-a0ba-11e4-b146-577832eafcb4_story.html); *Former Law Enforcement Officials Ask Ford Motor Company To Apologize And Withdraw Lies About Them From False Affidavits Prepared By Ford*, PR NEWSWIRE (October 9, 2015) (available at: http://www.prnewswire.com/news-releases/former-law-enforcement-officials-ask-ford-motor-company-to-apologize-and-withdraw-lies-about-them-from-false-affidavits-prepared-by-ford-300156904.html); D. Carrington, *Four More Carmakers Join Diesel Emissions Row*, THE GUARDIAN (October 9, 2015) (available at: http://www.theguardian.com/environment/2015/oct/09/mercedes-honda-mazda-mitsubishi-diesel-emissions-row); R. Sherefkin, *Lee Iacocca's Pinto: A Fiery Failure*, AUTOMOTIVE NEWS (June 16, 2003) (available at: http://www.autonews.com/article/20030616/SUB/306160770/lee-iacoccas-pinto:-a-fiery-failure).

15 R.P. Rogers, *The Effect of State Entry Regulation on Retail Automobile Prices*, Bureau of Economics Staff Report to the Federal Trade Commission (January 1986) at p. 3 ("the market supply curve is positively sloped") (available at: https://www.ftc.gov/reports/effect-state-entry-regulation-retail-automobile-markets).

16 Moriarity Letter, *supra* n. 8.

17 M.L. Walden, *Do Geographic Entry Restrictions Increase Car Prices?*, 35 REVIEW OF REGIONAL STUDIES 231-245 (2005) (available at: http://www.uam.es/personal_pdi/economicas/rarce/pdf/modelo_precios_coches_usa.pdf).

18 J.M. Barron & J.R. Umbeck, *The Effects of Different Contractual Arrangements: The Case of Retail Gasoline*, 27 J.L. & ECON., 313−28 (1984); Michael G. Vita, *Regulatory Restrictions on Vertical Integration and Control: The Competitive Impact of Gasoline Divorcement Policies*, 18 J. REG. ECON. 217−33 (2000); and A.A. Blass & Dennis Carlton, *The Choice of Organizational Form in Gasoline Retailing and the Cost of Laws that Limit that Choice*, 44 J.L. & ECON. 511−24 (2001).

19 Moriarity Letter, *supra* n. 8, at ft. 9, 22; Walden, *supra* n. 17.

20 G.R. Bodisch, *Economic Effects of State Bans on Direct Manufacturer Sales to Car Buyers*, Economic Analysis Group, Competition Advocacy Paper, EAG 09-1 CA, Federal Trade Commission (May 2009) (available at: https://www.justice.gov/atr/economic-effects-state-bans-direct-manufacturer-sales-car-buyers).

21 J. Ramsey, *WaPo Dismisses DOJ Report on Tesla Direct Sales,* AUTOBLOG (March 3 2015 (available at: http://www.autoblog.com/2015/03/03/wapo-dismisses-doj-report-tesla-direct-sales) ("Asked about that huge misstep, Bodisch said, 'I guess I was not aware of that at the time.' He sourced his information from the Internet, and somehow never got around to step number one in the due diligence phase, calling GM, if for no other reason than to ask why no one had anything to say about Celta direct sales after 2006. His paper lives on, though, because it's being used—most recently in January and February of this year—to help promote Tesla's fight to establish direct sales. The Tesla site has a now-empty page where the report was hosted, and Bodisch promotes his paper as being key in state government debates on dealer franchise laws—the same paper that Fact Checker gave four Pinocchios, its worst, 'Whopper' rating for breaking the laws of truth.")

22 *Rogers*, *supra* n. 15.

23 *Rogers*, *id*. at p. 2 ("In the rapidly growing areas (the second general situation), the RMA laws could benefit dealers through another mechanism. In this kind of area, the manufacturers may find it optimal to establish new franchises to handle the increased demand. If this process were frustrated, or at least partly frustrated, by the entry laws, excess demand

## NOTES CONTINUED:

would be created for the existing dealers allowing them to increase their sales volume. When the established dealers increase output, they may find that their average cost rises. This would cause them to increase price. While the market supply curve may be flat if the number of dealers is variable, it could very well be upsloping when the number of dealers is held constant or at least held close to constant.").

24 *Id.* at p. 11.

25 *See* T.R. Beard, G.S. Ford, and L.J. Spiwak, *The Price Effects of Intra-Brand Competition in the Automobile Industry: An Econometric Analysis,* PHOENIX CENTER POLICY PAPER NO. 48 (March 2015) (available at: http://www.phoenix-center.org/pcpp/PCPP48Final.pdf).

26 *Id.*

27 Opening Remarks of Edith Ramirez, *supra* n. 4 at p. 3.

28 Becker, *supra* n. 7.

29 §§ 445.1561-445-1583, Michigan Compiled Laws Annotated; §§ 19.856(21)-19.856(43), Michigan Statutes Annotated.

30 R.N. Block and D. Belman, *Automotive and Other Manufacturing Industries in Michigan: Output, Employment, Earnings, and Collective Bargaining, 1980-2001*, in MICHIGAN AT THE MILLENNIUM: A BENCHMARK ANALYSIS OF ITS FISCAL AND ECONOMIC STRUCTURE, C. Ballard, P. Courant, D. Drake, R. Fisher, and E. Gerber, eds., (2003) at pp. 145-68 (available at: https://msu.edu/~block/documents/BlockBelman2003MichiganattheMilennium.pdf).

31 K. Hill and D. Menk, *Contribution of the Automotive Industry to the Economies of All Fifty States and the United States*, Center for Automotive Research (January 2015) (available at: http://www.autoalliance.org/files/dmfile/2015-Auto-Industry-Jobs-Report.pdf) at Tables 3.2 and 3.3.

32 FTC staff has made such an argument in Moriarity Letter, *supra* n. 8 at p. 3 ("The report found that these state laws harmed consumers because they caused motor vehicle prices to rise.") The study cited by staff has been criticized and other studies published since, using superior methodologies and larger samples, finding opposing results. Such claims are also belied by evidence indicating that new cars are sold at exceedingly small margins. *See*, *e.g.*, *NADA Data 2014*, *supra* n. 10.

33 *Consumer Expenditures 2013*, Economics News Release, Bureau of Labor Statistics (September 9, 2014) (available at: http://www.bls.gov/news.release/pdf/cesan.pdf).

34 Peltzman, *supra* n. 7.

35 https://revenue.alabama.gov/salestax/cutax.cfm.

36 Statistics indicate that automobile dealers operate on pre-tax net margins of only 2.2%. *NADA Data 2014*, *supra* n. 11 at p. 3; P. Reed, *Where Does the Car Dealer Make Money*?, EDMUNDS.COM (December 3, 2013) (available at: http://www.edmunds.com/car-buying/where-does-the-car-dealer-make-money.html); Bodisch, *supra* n. 20 at Figure 1.

37 *Id*. at p. 5

38 For two reasons, we do not focus on the competitive effects. First, both the manufacturer and distribution of automobiles are workably competitive. In fact, it could be argued that auto distribution is excessively competitive. *See, e.g.*, Beard, Ford, and Spiwak, *supra* n. 25; J. Flint, *Too Many Dealers, Again?* WARD'S AUTO WORLD (September 2007). Second, states are not precluded from regulating the details of the competitive landscape generally and specially in auto retailing. *See*, *e.g.*, *New Motor Vehicle Board of California*, *supra* n. 11 at p. 439 ("if an adverse effect on competition were, in and of itself, enough to render a state statute invalid, the States' power to engage in economic regulation would be effectively destroyed.")

39 This argument is made by the automobile dealers; *see*, *e.g.*, https://www.nada.org/getthefacts.

40 *NADA Data 2014*, *supra* n. 10; *Where Does the Car Dealer Make Money*? *supra* n. 36. Trade in used vehicles is outside the scope of our analysis.

## NOTES CONTINUED:

41 While various Internet sites list consumer complaints about dealer services (e.g., complaintslist.com), satisfaction with car dealer services is actually quite high. *See, e.g.*, G. Hoffman, *How Dealers Are Making Consumers Happier These Days: Are You One of Them*, AUTOBLOG (March 23, 2011); *Despite Three-Year Increase in Recalls, Satisfaction among Recall Customers Continues to Climb*, J.D. Power (March 18, 2015) (available at: http://www.jdpower.com/press-releases/2015-us-customer-service-index-csi-study#sthash.AuTuiOny.dpuf).

42 *Id.*

43 This result conflicts with staff's view expressed in the Moriarity Letter, *supra* n. 10 at p. 6 ("Advocates for existing dealers also argue that manufacturers that sell directly to consumers will not provide them with adequate service. This argument presupposes that auto manufacturers in a competitive environment will act contrary to their economic self-interest. If consumers greatly value post-sale service and would be unlikely to purchase or recommend any automobile without a reasonable assurance of quality future service, then any manufacturer will have an incentive to supply such service or would see its sales decline to the benefit of its rivals. This competitive pressure is a strong motivation for manufacturers to either provide good service themselves or continue to contract with an independent service provider, such as a dealer, to do so.").

44 *Id.* at p. 2

45 *Id.*

46 *Id.*

47 D.L. Kaserman and J.W. Mayo, GOVERNMENT AND BUSINESS: THE ECONOMICS OF ANTITRUST AND REGULATION (1995), at Ch. 10.

48 *Comment of Fiona Scott Morton*, FTC Workshop Project No. P131202 #339 (Filed January 25, 2016) (available at: https://www.ftc.gov/policy/public-comments/2016/01/25/comment-339).

49 R.D. Blair and F. Lafontaine, THE ECONOMICS OF FRANCHISING (2005).

50 Kaserman and Mayo, *supra* n. 47; P. Rey, *The Economics of Franchising*, Working Paper, Institut des Mathématiques Economiques (November 1991) (available at: http://lara.inist.fr/bitstream/handle/2332/2376/IME-DT_91-15.pdf?sequence=1).

51 Scott-Morton, *supra* n. 48.

52 Rey, *supra* n. 50 at p. 16.

53 *See* Beard, Ford, and Spiwak, *supra* n. 25.

54 *See* Scott-Morton, *supra* n. 48 ("That is why I, and others, have found that the [retail markup] falls with more dealers, or the amount of intra-brand competition.")

55 W.M. Landes and R.A. Posner, *Market Power in Antitrust Cases*, 94 HARVARD LAW REVIEW 937-996 (1981).

56 For a discussion of why this is true, *see* G.S. Ford, *The Road to Nowhere: Regulatory Implications of the FCC's Special Access Data Request*, PHOENIX CENTER POLICY PERSPECTIVE No. 16-02 (February 23, 2016) (available at: http://phoenix-center.org/perspectives/Perspective16-02Final.pdf).

57 *See generally*, L.J. Spiwak, *Direct Auto Sales Could Raise Car Prices*, DETROIT NEWS (April 2, 2015) (http://www.detroitnews.com/story/opinion/2015/04/02/spiwak-franchise-laws/70789162).

58 J. Cobb and M. Mayersohn, *Why Do We Keep Buying Vehicles at Dealerships?*, CAR & DRIVER (October 2015) (available at: http://www.msn.com/en-us/autos/news/why-do-we-keep-buying-vehicles-at-dealerships/ar-AAeZXDJ) ("There has been a focus on outdated laws that protect dealers, but there is that consumer issue, and it is a real one," says Aaron Jacoby, chair of the automotive industry practice group at Arent Fox, a Washington, D.C.–based law firm. "Laws are still geared toward protecting consumers, and there is interest in how they will get service for these major expensive things they are buying. How will recalls be handled? How will warranty work be handled?").

## NOTES CONTINUED:

59 Opening Remarks of Edith Ramirez, *supra* n. 4.