Consumer Federation of America

A ROADBLOCK ON THE INFORMATION SUPERHIGHWAY: ANTICOMPETITIVE RESTRICTIONS ON AUTOMOTIVE MARKETS

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Consumer Federation of America

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EXECUTIVE SUMMARY

AN EMERGING, NEW ECONOMY CONSUMER ISSUE

The summer of 2000 was hot in Texas, not only because of the weather and presidential politics, but also because of a fiery clash between the old economy and the new in sale of new automobiles. Aggressive action by the Texas Motor Vehicle Division against efforts by a variety of entities to sell automobiles directly to the public came to a head in lawsuits and complaints. A *Wall Street Journal* article noted, ironically that "Texas even prohibited sales of cars by online companies, making it illegal for CarOrder.com to sell in its home state."

The object of this heated dispute is a law that restricts the marketing of automobiles to new car dealers and prevents manufacturers or brokers from selling directly to the public. Most states have had some version of these laws on the books for about a quarter of a century, but as the Internet brings pressure to bear on middlemen, auto dealers have endeavored to make the restrictions even stronger and pushed state governments to enforce them more aggressively.

This report examines the empirical evidence on the impact of vertical restraints in the automobile dealership markets and finds that the evidence overwhelmingly supports the conclusion that the restraints are not in the consumer or the public interest. It examines the effects of lifting restraints, finding substantial potential gains for consumers.

At this early stage of the growth of Internet usage for new automobiles and other products and given the severe restraints on trade that have been places on the sales of new autos, it is only possible to give an order of magnitude estimate of potential savings. Based on the econometric estimates of the excess costs imposed on the public by laws that restrict entry of new auto dealerships, analyses of the cost structure of the current auto distribution network, and the growing body of econometric evidence on the cost savings and price reductions associated with Internet sales, savings of 10 percent per car are readily achievable over time. That would amount to $2,500 per car at today's prices, which means tens of billions of consumer savings per year.

The detailed studies of the impact of restrictive franchise laws done before the Internet dramatically increased potential efficiency gains from a more streamlined distribution system found potential savings of at least 6 percent per vehicle. At today's prices and volumes the potential savings are on the order $1,500 per vehicle, or more than $20 billion per year.

The report also examines potential unintended negative effects that have been invoked by dealers to defend or extend laws restraining direct sales of automobiles and finds that there is little likelihood that these negative consequences would materialize. Increased competition would make it difficult for any party to gain market power, warranties would remain in force, and the quality repair and maintenance services would likely improve because the best dealerships would expand.

The public policy conclusion is overwhelmingly clear, restrictions on entry into the automobile dealership market and direct selling to the public make little sense at the start of the "Internet Century." They should be repealed and efforts to strengthen them in the face of the growth of the Internet should be resisted. As competition in introduced into the distribution of automobiles, consumers would continue to have the full protection of general consumer protection statutes and the array of laws that apply specifically to automobiles. Restricting entry into the auto dealer business is an inefficient and not very consumer-friendly way to achieve this consumer protection.

Allowing new entrants into the sale and distribution or automobiles does not mean that they would be deregulated. A balance should be struck between reasonable licensure or bonding requirements and the need to allow efficiency and competition between a full array of sellers and opens new. A balance should also be struck between opening distribution channels and concerns that manufacturers will discriminate against dealers or others in making automobiles available. Where auto manufacturers are allowed to sell directly to the public, requirements that manufacturers not discriminate against dealers, against whom they would be competing, in the availability and price of vehicles should be considered.

More than just the tens of billions of consumer savings on new auto purchases is at stake, since the outcome of this battle could shape the way the use of the Internet rationalizes transaction throughout the economy.

AN OLD ECONOMY RESTRAINT ON TRADE

The automobile is the quintessential symbol of the industrial economy of the twentieth century. One of the key elements in the success of the U.S. automobile industry was the creation of a ubiquitous network of independent dealerships – middlemen – to sell, distribute and service automobiles. Dislodging this entrenched distribution network may make it a potentially intense battleground when the new economy meets the old.

The automobile is an expensive, long-lived commodity that requires post-purchase maintenance. Dealerships have traditionally involved substantial investment. Early in the development of the industry, automobile dealers and manufacturers voluntarily agreed to establish exclusive territories based on the belief that without some reasonable assurances about a market for their services, middlemen will not make the necessary investment in the local network or make the necessary outlays on advertising and service to support the product. The manufacturer needed middlemen to make the product attractive to consumers. To make the necessary investment, the middlemen need assurances that their market will not be constantly under attack by new dealers or their services will not be "stolen" by free riders.

THE ANTICONSUMER EFFECTS OF RESTRICTIONS ON ENTRY

Whatever benefits this voluntary restraints on trade might have produced in the development of the industry, by the 1970s, the restraints had outlived their usefulness. Increasing competition and improving product quality had undermined the economic function of exclusive arrangements. As the economic foundation of exclusive dealerships was eroded, dealers responded by seeking laws to prevent erosion of their monopolies. In 1970, only two states restricted entry. By 1983, three dozen states had adopted these restrictions. Today the number is 41. In the last few years, as the potential for Internet transactions has increased, dealers have increased political pressures to seek even more restriction on direct sales to the public and more aggressive enforcement of existing provisions.

Empirical econometric evidence clearly supports the conclusion that restrictions on entry harms consumers. Over a dozen empirical studies and regulatory reviews of territorial restraints on distribution have consistently found that they result in higher prices to consumers.

- Restrictions on entry and distribution channels reduce the number of dealers creating local market power for the protected dealers and resulting in higher margins for dealers, and higher prices for consumers – in the range of 6-8 percent per car.

- The longer the laws are in effect and the faster the market is growing, the greater the impact was found to be. Time and growth are important since it is the reduction of dealerships relative to the market that enhances market power.

Although the economic studies of vertical restraints on automobile dealerships were conducted in the early 1980s, studies of Internet sales of automobiles have begun and these support the conclusions of the earlier analysis from the opposite direction. That is, the early studies showed that restrictions on entry hurt consumers. The contemporary studies indicate that entry of new marketers and new marketing methods helps consumers and lowers prices in the range of 9 to 16 percent.

THE EFFICIENCIES OF LIFTING RESTRAINTS ON AUTO SALES

By creating an environment in which producers and consumers can interact directly, the information economy and its highest form of public organization, the Internet, promises to dramatically alter and threatens to reduce the role middlemen play throughout the marketplace.

- From the consumer point of view, the ability to gather information online facilitates comparison shopping, a daunting task in the new automobile marketplace.

- Higher and higher quality visual and video images that can be tailored and modified during the transaction, promise a quantum leap in the quality of marketing and consumer information gathering.

- Increasing integration of production with consumer preferences identified through on-line transactions can both dramatically reduce marketing and reduced inventory/holding times for the delivery of goods.

- Personalized selling and flexible production can combine with interactive scheduling to reduce the amount of time that goods must be held in storage or spent in transit, sharply reducing delivered costs on big ticket items like automobiles.

Estimates of cost savings resulting from these efficiencies are subjective, but are generally put in the range of 10 percent per car.

VALUE OF POTENTIAL CONSUMER SAVINGS

Consumers would pay considerably less for new automobiles as a result of the lifting of these restrictions on sales. These savings would come from two cumulative sources – elimination of the power automobile dealer exercise over pricing through their protected monopoly status and efficiencies that would be introduced into the distribution process.

The research into the impact of marketing restrictions consistently shows price increases associated with restrictions in the range of 6-8 percent of the final sales price.

- For an automobile costing about $25,000 per automobile, elimination of market power would yield potential cost savings to consumers in the range of $1,500 to $2,000 per vehicle.

- Efficiency gains from build-to-order and direct selling have been estimated to be in the range of $2,000 to $2,500, or about 10 per cent, per vehicle.

- A growing body of literature on the cost savings and price reductions resulting from the use of the Internet puts consumer savings in the range of 10 to 15 percent.

Because the automobile is such an important consumer commodity the total dollar amounts are large. For example, the total sales through new car dealers totaled almost approximately 14 million units in 1999 with a total value of over $350 billion. Thus, even at the lower range of these estimates, total long runs savings would amount to tens of billions of dollars per year. The gains would build slowly, as increasing use of direct sales eroded the pricing power of dealers and transformed the distribution system.

MARKET STRUCTURE AND PERFORMANCE WITHOUT RESTRAINTS

In seeking to prevent the entry of new distribution channels, the dealers make a variety of claims about negative effects of direct sales to consumers. Some, like local philanthropy, are purely parochially self-interested. Claims about market structure, however merit examination. These do not withstand close scrutiny.

One claim is that automobile manufacturers would vertically integrate into dealerships to such an extent that they would eliminate independent dealers and be able to exercise market power over prices by eliminating competition between dealers selling the same cars (intrabrand competition. Analysis of the automobile market structure (market shares) and industry behavior (advertising and discounting) indicates that this is unlikely because competition between automobile manufacturers (interbrand competition) drives the market. As a consequence, efficiency gains resulting from the rationalization of distribution would likely be passed through to consumers.

A second claim that is frequently made is that direct sales of autos to the public would undermine the auto service and repair business. This is highly unlikely since restrictions on entry and exit have prevented new car dealers from competing to provide non-warranty service. The growth of an independent service sector in the past decade is strong evidence that service has become a competitive, stand alone business.

This points directly to a third claim that is misleading – the assertion that buying directly from the manufacturer or from a broker would undermine the value of auto warrantys. The warranty is an obligation of the manufacturer, not the dealer. If the vertical restraint were lifted, dealers would have to compete more vigorously for warranty work and consumers would benefit from a more responsive service marketplace.

PUBLIC POLICY

The public policy recommendation that emerges is straightforward – more competition would be better. Allowing automobile manufacturers and third parties to sell directly or provide information services to the public adds a more efficient sales channel and should be encouraged, if proper safeguards against the exercise of market power are in place.

Restrictions on direct sales by automobile manufacturers and others to the public should be removed. A balance should be struck between the need to impose licensing and other requirements on new entrants into the automobile sales business to ensure consumer protection and the need to open this important market to more competition.

Similarly, where auto manufacturers are allowed to sell directly to the public, a balance should be struck between requirements that manufacturers not discriminate against dealers in the availability and price of vehicles and the need to allow competition to rationalize automobile distribution.

The current heavy-handed restraints on distribution channels are a most inefficient and consumer-unfriendly approach to consumer protection. They deny consumers huge cost savings and improved convenience and quality of service.

I. INTRODUCTION

I. A. BANNING ONLINE CAR SALES IN TEXAS

The summer of 2000 was hot in Texas, not only because of the weather and presidential politics, but also because of a fiery clash between the old economy and the new. Aggressive action by the Texas Motor Vehicle Division against efforts by a variety of entities to sell automobiles directly to the public came to a head. As the *Fort Worth Star-Telegram* put it

> Internet-savvy Texas consumers can buy almost anything from the legion of dot-com businesses that only sell online, from clothes and groceries to life insurance or a computer system.
>
> But not a new car.
>
> A representative of the state's Motor Vehicle Division says a 1960s-era provision of state law that outlaws car brokers also prohibits car-buying services. Under the law, only licensed auto dealers can sell cars, and only a dealer with a manufacturer's franchise can sell new cars.[1]

While the battle has been playing out in a number of states, Texas appears to be a focal point because of the aggressiveness of the action against Internet sales in the state. Following the twists and turns of the struggle over direct, Internet sales of autos in Texas reveals all of the elements of a major debate over public policy toward Internet-based economic activity.

> While Texas consumers can shop for a car on the Internet by using Web sites that direct them to local dealers, Texas was the first state – and one of only a few – that have banned sales by online companies. Analysts say that Oklahoma and Arkansas have pursued similar policies. Mike Morrisey, spokesman for the National Automobile Dealers Association, says dealers in other states envy the stand taken by Texas regulators.[2]

The intensity of the debate in Texas stems from a combination of a very restrictive franchise law and a particularly aggressive approach to implementing it.

> Dealers have already used their political muscle over the last 12 months to persuade lawmakers in nine states to tighten state franchise laws, making it virtually impossible for manufacturers to sell cars except through franchised dealers. Governor George W. Bush, the front-runner for the Republican presidential nomination, signed the toughest such law in the nation last year, and the Texas Department of Transportation has become the nation's leader in becoming stricter on Internet commerce involving cars.[3]

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[1] Cox, Bob, "Texas Law Limits Online Sales: State Says Dealers Protected, Others Say Consumer Hurt," *Fort Worth Star*, July 9, 2000.
[2] Ibid.
[3] Bradsher, Keith, "Car Dealers' Driveway Blues," *New York Times*, January 25, 2000.

Carol Kent, director of enforcement for the Motor Vehicle Division says her office is merely enforcing a law that protects consumer and auto dealers alike. Kent says that brokers, unlike dealers, might not be around later to fix defective cars and answer for their sins. Internet companies, Kent says, are merely high-tech brokers, since they either buy cars from dealers or arrange a sale between the consumer and the dealer. The law is also intended, Kent acknowledges, to protect local dealers, who have made multi-million dollar investments in new-car franchises, building dealership facilities and operating service departments.[4]

II. B. EXPANDING CONSUMER SHOPPING ALTERNATIVES

Interestingly, although the auto manufacturers have pushed the fight into the courts in an effort to loosen the restrictive laws,[5] the battle in Texas started with brokers, not auto manufacturers and focused on the ability of Internet companies to charge fees for facilitating car sales.

CarsDirect.com was the first company to attempt direct Internet sales in early 1999 and quickly found trouble in Texas. Kent's office filed a complaint last fall charging that the company was either operating as an unlicensed dealer or a broker.

Priceline.com, the Internet service that allows consumers to buy discount airline tickets and hotel rooms, began arranging car deals for consumers last fall, but found that it couldn't legally operate in Texas. Consumers submit bids for a car or truck to Priceline, which then sends the bid to area dealers. Dealers are free to accept a bid or make a counter-offer. When a sale is made, Priceline collects a fee from the dealer and a smaller fee from the buyer.

Under Texas law, the fee made Priceline a broker. But Maryann Keller, president of Priceline's auto sales unit, says Priceline considered it so important to do business in Texas that it decided to operate within the law – and dropped its fee. "We discovered that if you do business for free, it not illegal," Keller says.

It isn't just the online brokers that Kent's office has taken to task. Internet referral services like Autobytel and Autoweb have also run afoul of the state agency. As far back as 1996, Kent's office ruled that Autobytel was a broker because it charged dealers a fee each time it passed along the name of a prospective car buyer. The company was ordered to adopt a flat rate price, regardless of the number of leads sent to a dealer or the size of the dealership.[6]

Brokers bristle at the uneconomic arrangements that the law imposes on them. Either they accept terms that are highly favorable to dealers or they shut down altogether.

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[4] Cox.
[5] "Tire-Kicking on the Web," *Wall Street Journal*, August 31, 2000 (Tire-Kicking).
[6] Ibid.

> Autoweb says this model defies normal business practices – dealers would pay the same amount for referrals from consumers in a sparsely populated West Texas ZIP Code as they would for referral in a posh North Dallas ZIP Code. And the system works to the benefit of large dealers, because dealers pay a flat fee for each franchise they include in their inventory listing on the Web.[7]

Perhaps the most ironic twist of the state statute is the suggestion by the state director of enforcement that the easiest way to comply with the law is “to simply take the price off the Internet and leave that up to the dealer.”[8]

Once the conflict over the ability to sell to the public starts, it escalates sharply, since being foreclosed from a potentially powerful sales channel like the Internet can dramatically alter the ability of entities to survive. Prevented from dealing directly with the public, automobile manufacturers have not been pleased to see other intermediaries inserted between the manufacturer and the consumer in an effort to exploit loopholes in state franchising law. As an auto industry analyst from J.P. Morgan Securities put it in the *Wall Street Journal,* “dealers have forced Big Three automakers to “blacklist” online businesses. Manufacturers have responded by “creating rules that make it very difficult for direct-sales companies to get vehicles.”[9]

> Amazon.com, one of the world’s largest online retailers, announced yesterday that it will begin offering a car-selling service on the Internet, the latest and potentially most serious challenge to the ability of automakers to control the distribution of automobiles…
>
> Amazon will market automobiles through an alliance with Greenlight.com, a privately held online company owned by several big chains of auto dealerships…
>
> By requiring customers to buy vehicles from dealers at the end of the process, Amazon and Greenlight hope to circumvent restrictive state laws that have entangled companies that have sought to buy cars from dealers and actually resell them to consumers. Greenlight has affiliated dealers in 27 metropolitan areas who will provide the cars for the venture.
>
> Jeff Bezos, Amazon’s founder and chief executive, and Joel Manby, the chief executive of Greenlight, said their companies had carefully designed the plan to comply with state laws.
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> Ford Motor Co. criticized the plan, saying that it did not allow dealers to play a large enough role in selling the vehicles. Stephen Lyons, Ford’s general sales manager, said

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[7] Elder, Robert Jr., and Jonathan Weil, “To Sell Cars in Texas, Online Firms Are Forced to Enter the Real World,” *Wall Street Journal*, January 26, 2000.
[8] Swaboda, Frank, Warren Brown, “Ford Takes on Texas in Web Sales Dispute,” *Washington Post*, December 17m 1999.
[9] McWilliams, Gary, “E-Business: CarOrder.com Backs Out of Online Auto Retailing,” *Wall Street Journal*, August, 21, 2000.

the arrangement essentially amounted to brokering cars that are purchased from dealers – an activity that some states prohibit.[10]

The Texas statute eliminates the three-way tug of war between dealers, brokers and manufacturers by banning both brokers and manufacturers from dealing directly with the public, leaving the dealers in control of the customer. A *Wall Street Journal* article pointed to the irony in the fact that "Texas even prohibited sales of cars by online companies, making it illegal for CarOrder.com to sell in its home state."[11] Squeezed as a broker and frustrated in becoming a dealer, CarOrder.com ceased operations as an online seller of autos.[12]

The battle ground is not limited to America. As one recent press account noted "auto dealers from Europe and the Americas plan to create a global lobby at a forum here this month to fight automakers who are selling directly to consumers over the Internet."[13] The European Commission issued a major report generally questioning restraints on the marketing and distribution of automobiles.[14]

Nor is the battle restricted to online sales. An Argentine official worried about sales spreading to other locations.

> Another concern here is we have supermarkets that might sell gas; will they start selling new cars too?" AADA Executive Director Oscar Cortis said.
>
> Argentina is considering allowing supermarkets to sell gasoline, so auto dealers see their business threatened on two fronts, the other being on the Internet.[15]

Less than two months later, half a world away, supermarkets in the United Kingdom actually did enter the fray by selling cars.

> Sainsbury's yesterday became the first British supermarket to start selling cars, intensifying the competition in the car market at a time of unprecedented change for the motor industry.
>
> Private car buyers who prefer not to go to their local dealer could choose instead from specialized importers and online retailers or even go direct to the manufacturer. Now they will be able to order their new model along with the week's groceries.[16]

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[10] Bradsher, Keith, "Amazon.com Adds Cars to Its Wars – but You Won't Get Autos via UPS," *San Diego Union-Tribune*, August 24, 2000.
[11] McWilliams.
[12] Vertuno, Jim, "CarOrder.com Lays off 100 People, Suspends Web Site," *Associated Press Newswires*, August 21, 2000.
[13] LeGras, Gilbert, "Auto Dealers Plan to Fight Internet Sales," *Reuters*, June 6, 2000.
[14] European Commission, *Report of the Evaluation of Regulation (EC) No. 1475/95 on the Application of Article 85(3) of the Treaty to Certain Categories of Motor Vehicle Distribution and Servicing Agreements* (Brussels, 2000).
[15] LeGras.

I. C. WINNERS AND LOSERS

Clearly, revolutionary forces are buffeting the industry and the stakes are huge for all parties. Everyone claims to be representing the consumer, but the clash between the special interests vested in the old economy and the powerful forces of the new economy immediately bubble to the surface.

> In the past 18 months, several online service have sprung up that promise to sell consumers a car or truck at an attractive price without ever venturing onto a dealer's lot. The companies act as middlemen, finding a vehicle for a customer at the price they want to pay. "People want the service," says Brian Stafford, president of CarOrder.com, an Austin-based company that's doing business in many states, but not Texas. "We find people love to be able to order a car online and have it delivered to their home..."
>
> "It would not be fair if you allowed some broker to set up across the street in a 3-by-5 office doing the same thing as a franchise dealer," Kent says. An Internet buying service is just a broker, she says, one that doesn't even rent an office.
>
> So why should car dealers be protected from Internet competitors when other businesses are not? Kent says the economic contribution dealers make to local communities, in terms of job creation and philanthropy, is an important consideration. Plus, she says, auto sales are a regulated industry and it would not be fair to dealers to allow unregulated competition.
>
> Texas auto dealers say they don't want the state's regulations changed because it would be unfair to have to compete for sales with companies that have no ties in the community.
>
> "I have a lot of money invested in bricks and mortar," says Cliff Johnson, owner of Texas Motors Ford in Fort Worth. "My money stays here in town."
>
> That rationale doesn't wash with Daniel Howard, chairman of the marketing department at Southern Methodists University's Cox School of Business. "Is it the role of a government agency to dictate to the people the avenues they can and cannot use to make a purchase?" Howard says. "It seems to be to be interest-group politics." Kent's office is directed by the Texas Motor Vehicle Board, a nine-member body appointed by the governor, which includes two car dealers.[17]

Ironically, there are some who believe that the automaker efforts to use the Internet for direct sales to the public could unleash competitive forces that they could not control.

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[16] Harrison, Michael, "News Analysis: Sainsbury's Joins the Revolution in Car Retailing: Traditional Dealers are Facing Competition on the Forecourts from Supermarkets as well as Online Suppliers," *The Independent*, August 15, 2000.

[17] Cox.

> Ford and the Dealer Council say consumers will get an "e-price" using FordDirect.com, which is the highest price they will pay for the vehicle. From there, they can come to the dealer and further negotiate the price.
>
> Even if consumers bombard the Web with vehicle transactions, Ford still wouldn't gain a victory in the market because it would drive customers to look at many different vehicles, which would spark more competition, Spinella [vice president of a firm that tracks Internet buying] said. "That's one of the worst things that could happen," Spinella said. "That could actually take customers away from Ford because they could look at every option out there. It's harder for customers to comparison shop when they are going physically to the dealer."[18]

The automakers argue that dealers would not be eliminated, if direct sales were allowed, because dealerships would continue to provide key functions.

> "Dealers will still do the sales and service," said Jim Schroer, director of global marketing for Ford Motor Co. "People think there will be another distribution system. That's not the case."[19]

Underlying the debate are general attitudes toward the Internet-based economy and major policy issues.

> Some states that ban car brokers have found a way to allow Internet car sellers to operate. California requires them to have an office and state-licensed staff, much like a dealer. But Texas has just said no, and that bothers state Rep. Rick Green, R-Dripping Springs. Green says the state's policy hurts both consumers and the state's ability to attract Internet companies to locate here.
>
> "They've basically run these companies out of Texas. In my opinion, that's the wrong thing to do," Green says. "They're not protecting consumers, they're protecting dealers. Green says that, if the state regulators don't change their attitude toward online car sellers, he may sponsor legislation next year to change the law.
>
> Kent bristles at those who suggest Texas should change its rules to welcome e-commerce. "Those big Internet companies come in with all their money and want to do things their way," she says.[20]

The Cato Institute, a conservative think tank in Washington has recently taken a look at the question of who benefits from these restrictions of competition and concluded that the consumer is the loser. [21]

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[18] Parker, Jocelyn, "Ford-Dealer Web Venture May Draw Buyers, But How Many?" *Dow Jones News Service*, August 28, 2000.
[19] Child, Charles and Donna Harris, "Dealers, Factories Unite on Net Sales," *Automotive News*, January 31, 2000.
[20] Ibid.

> Consumers seem to prefer choice to paternalism; surveys show that from 60 to 70 percent of consumers object to legislative actions restricting online car sales. Even traditional consumer groups, generally not known for supporting deregulation, are concerned that franchise laws that restrict online sales do not serve consumers.
>
> Consumers' interest in reliable local service suggests that they would also have a strong interest in dealerships that provide fast and honest service. Franchise laws have impeded the evolution of such dealerships. It would have been logical, for example, for dealerships to have been the first to offer fast, inexpensive routine maintenance, but Jiffy Lube and its competitors beat them to the punch. A type of franchise law known as a Relevant Market Area Law prevents dealers from pursuing the option first, because RMA laws give dealers within one market the power to oppose "disruptive" innovations such as service centers put forward by other dealers.
>
> Laws that "protect" the consumer are likely to do more harm than good when they restrict competition. There's a big difference between a lemon law, which provides a remedy for a close cousin of fraud, and law that blocks for certain sellers an honest deal on the Internet from going through. The first law does not restrict competition in any meaningful way, but a law that prevents new outlets for car sales from opening on the Internet certainly does. From the consumers' standpoint, restrictions on Internet auto sales look like another way to deny them choice and cost savings.[22]

The fact that consumer groups have joined the opposition to these restrictive statutes is reinforced by the observation that there are few consumer complaints about Internet auto sales where there are permitted.

> Indeed, state regulators say the only compla ints they have been receiving about the services have been from dealers, not consumers. There is mixed evidence on whether consumers save money buying cars online…
>
> A dozen regulators said in separate interviews that while complaints about the new services had been coming from dealers, not consumers, they believed that consumers could someday be hurt by insufficient regulation of the new companies.[23]

I. D. BROADER IMPLICATIONS

The outcome of this battle and what we learn from it may define the way many similar disputes are resolved. Many other conservatives see each effort to resist direct sales as symbolic of the broader rationalization of transactions in the information economy. Murray Weidenbaum warns that "Auto dealer success in obtaining restrictions is an early warning to other industries where manufacturers are thinking about the Internet to sell directly to the

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[21] Singleton, Solvieg, *Will The Net Turn Car Dealers into Dinosaur? State Limits on Auto Sales Online* (Cato Institute, July 25, 2000). Interestingly, because of the vigorous efforts to enforce the restrictions in Texas, it receives the greatest amount of attention in the Cato paper.

[22] Ibid.

[23] Bradhser.

consumer."[24] Similarly, an opinion piece in the *Wall Street Journal* draws parallels to other commodities.

> In the language of stone-age contempt for the New Economy, the judge ruled last month that if Ford were allowed to sell cars directly over the Web, "all state regulatory schemes would be nullified" as they "fall before the mighty altar of the Internet."
>
> There is hope. Texas, like a number of other states, also had a ban on direct shipment of alcohol. Basically, it was a crime for ordinary Texans to order a case of Chardonnay straight from their favorite Napa Valley winery instead of paying a Texas middleman. In February, Judge Melinda Harmon of Texas' Southern District got it right, and ruled that the state's ban on direct shipments of alcohol to consumers constituted economic protectionism and violated the Constitution's commerce clause, which expressly encourage competition.[25]

At the start of what has been called the "Internet Century," there can be no better symbol of the transformation of the economy than a battle over automobile sales on the Internet. The automobile is not only the quintessential symbol of the industrial economy of the twentieth century, it is also the second largest expense on a consumer durable that most households make. Potential savings in dollars and convenience for consumers are huge.

Not only is the automobile a perfect symbol of the industrial economy of the twentieth century in America, but the distribution network that typifies the industry has important and unique elements that make it a potentially intense battleground when the new economy meets the old. One of the key elements in the success of the U.S. automobile industry was the creation of a ubiquitous network of independent dealerships – middlemen – to sell, distribute and service automobiles. The automobile is an expensive,[26] long-lived commodity that requires post-purchase maintenance.[27] Historically, this created a unique relationship between the dealer and the consumer. The dealerships have traditionally involved substantial investment.[28]

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[24] "Auto Dealers Quash Internet Competition," *Christian Science Monitor*, August 17, 2000.
[25] Tire-Kicking.
[26] Gertzen, Jason, "Car Market Draws Internet Giants," *The Milwaukee Journal Sentinel*, August 27, 2000,

> But so far companies selling cars online have found their efforts running more like a chug-chugging rattletrap than a perfectly tuned Ferrari.
> Complex state laws and fierce resistance from automakers and dealers are among the reasons.
> Observers also are skeptical of the idea that buyers will spend $20,000 or more on a car they see only through flickering images on a computer screen.

[27] Roush, Matt, "NetNet Manager Foresees More Change Wrought by the Web," *Crain's Detroit Business*, May 1, 2000.

> It's easy to compare retail to retail, but selling PCs and selling autos are different," Said Chuck Fortinberry, president of Clarkston Chrysler-Jeep Inc. and secretary-treasurer of the Detroit Area Dealers Association, "You can't put your car back in the box and mail it to the factory to get it fixed. Also, most people want to touch and feel and drive an investment the size of an automobile.

[28] Weidenbaum notes the following:

> However, there is a special aspect of the auto industry that isn't universal in consumer products. Each auto dealer has invested substantially in obtaining and developing its franchise to sell products of a specific manufacturer – be it General Motors, Ford, Daimler-Chrysler, Toyota, etc. Correctly or not,

Whether these unique characteristics should prevent or slow Internet-based transactions from penetrating the distribution chain is unclear,[29] but a true test of the economics of direct sales would only come after the restrictive franchise laws are breached. Indeed, the fact that this firestorm has engulfed Internet sales of automobiles underscores the powerful forces of change in the distribution of goods and services. The automobile was believed to be a type of commodity that is not well suited to Internet sales.

> The Internet is expanding rapidly into every market and many geographic areas. While much attention focuses on so-called "new economy" businesses, an interesting aspect of the Internet revolution is the change being forced on traditional industries. The resulting threat to intermediaries such as traditional brokerage and music labels were not hard to predict, however, the impact of the Internet on some other industries was less clear. In 1995, for example, the popular press devoted much discussion to predicting the products for which the Internet would be a good sales channel. Cars were often considered a poor fit. After all, went the argument, consumers would always want to "kick the tires" before buying a car. While consumers remain interested in physically inspecting a car, the Internet has nonetheless become an important complement to the car-buying process. In 1999, for example, 25% of all consumers who were in the market for a new car used the Internet in conjunction with buying a car.[30]

In spite of these doubts about the efficacy of the Internet for car buyers, we find ourselves in the thick of an intense public policy debate, and no group better symbolizes the role of middlemen in the industrial economy than automobile dealers. Automobile dealers may also symbolize the difficult, yet highly favorable, changes that the transformation of the industrial economy into an Internet economy may bring. At the start of the twenty-first century this crucial element of the automobile market is coming under increased scrutiny.

Throughout the economy, vertical relationships between producers, distributors and consumers are changing and the role of middlemen is being subject to powerful economic forces as the information economy expands. By creating an environment in which producers and consumers can interact directly, the information economy and its highest form of public organization, the Internet, promises to dramatically alter and threatens to reduce the role middlemen play throughout the marketplace. As the capability to deliver information expands and access to multimedia, interactive information applications improves, pressure to change established distribution and marketing models will increase exponentially.

> dealers may believe they entered an implicit understanding that the manufacturer wouldn't compete against them. Of course, if that really were the case, there'd have been little need for the state laws, on auto sales; dealers could have gone to court.

[29] Vertuno, quotes a information industry analyst as follows:

> Selling cars online is more difficult than other products, said Leathern, the Jupiter Communications analyst. Customers spend a lot of time researching autos online but tend to go to dealerships for their purchase. "For something costing as much and getting as much consideration as a car, giving the consumer a reason to trust you is very important."

[30] Morton, Fiona Scott and Florian Zettelmeyer and Jorge Silva Risso, Internet Car Retailing (September 2000.

The prospect of reducing distribution costs by increasing efficiency is evidenced by a variety of observable improvements in the marketing process. These changes include more effective shopping by consumers and better targeting of marketing efforts, personalized design of products, and reduced inventory/holding times for the delivery of goods.

- Higher and higher quality visual and video images that can be tailored and modified during the transaction, promise a quantum leap in the quality of marketing and consumer information gathering.

- Increasing integration of production with consumer preferences identified through on-line transactions can both dramatically reduce marketing and inventory costs and increase customer satisfaction.

- Personalized selling and flexible production can combine with interactive scheduling to reduce the amount of time that goods must be held in storage or spend in transit, sharply reducing delivered costs on big ticket items like automobiles.

To achieve these potential gains, however, major institutional changes must come about. Powerful entrenched interests must accept a new role. Therein lies the source of the political debate.

I. E. OUTLINE OF THE REPORT

Although conservative commentators are uniformly opposed to restrictive franchise laws and some consumer groups have entered the fray because of the extremely draconian measures being pushed in some states, a review of the economic evidence on the impact of vertical restraints on dealership is needed before we make a general push for change. Because the U.S. auto industry is so huge and the role of the auto dealer as a middleman in the industrial economy so prominent, the result of the debate will have profound effects on not only the industry and consumers, but the economy in general. The empirical basis for policy recommendations should be particularly firm.

This paper examines the public policy implications of changing the relationship between automobile manufacturers, dealer and consumers. It is not a study of Internet sales, although it makes reference to some studies of that issue. Rather, it is a study of vertical restraints and their impact on automobile buyers. It is divided into three chapters.

Chapter II examines the empirical evidence on the impact of vertical restraints in the automobile dealership market historically and in today's economy. It finds that the evidence overwhelmingly supports the conclusion that the restraints are not in the consumer or the public interest.

Chapter III examines the possible effects of lifting those restraints, focusing on potential unintended negative effects that have been invoked to defend or expand vertical restraints. It finds that there is little likelihood that these negative consequences would materialize.

Chapter IV states the public policy conclusion. In short, restrictions on entry into the automobile dealership market and direct selling to the public make little sense at the start of the "Internet Century." They should be repealed and efforts to strengthen them in the face of the growth of the Internet should be resisted.

II. THE IMPACT OF VERTICAL RESTRICTAINTS ON AUTOMOBILE DISTRIBUTION

II. A. THE STRUCTURE, CONDUCT PERFORMANCE APPROACH TO THE ANALYSIS OF INDUSTRIAL ORGANIZATION

The image of the new Internet economy in which goods flow directly from producers to consumers with much less friction stands in sharp contrast to the industrial organization of the automobile market. In that industry, in many states, not only are producers precluded from selling directly to the public or owning local distribution points, they are not free to establish new franchises or alternate means to distribute their goods. Ongoing efforts to further restrict the manufacturer's role in marketing would push the automobile industry in the opposite direction of the integrated, on-line transactions that are being facilitated by the growth of the Internet and used by virtually every other major segment of our economy.

The various restrictions on the sale of automobiles fall into a category of economic relationships called vertical restraints. They are called vertical restraints because they impose some restriction on the flow of goods and services down the chain of distribution from the manufacturer to the consumer. Not only have these practices been the target of much analysis and criticism in the automobile industry, for about a quarter of a century they also have been among the most hotly debated practices in the broader industrial organization and antitrust arenas.

This paper uses the structure, conduct, performance paradigm (SCP) to evaluate the impact on consumers of vertical restraints on sales of automobiles.[31] The analytic framework enables us to understand the causes of the problems in the industry and arrive at policies to respond effectively. The elements of the approach can be described as follows.

In SCP analysis the central concern is with market performance, since that is the outcome that affects consumers most directly. The concept of performance is multifaceted. It includes both efficiency and fairness.[32] The measures of performance to which we traditionally

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[31] Scherer, F. M. and David Ross, Industrial *Market Structure and Economic Performance* (Boston, Houghton Mifflin: 1990), p. 4.

[32] Scherer and Ross, p. 4.

> We begin with the fundamental proposition that what society wants from producers of goods and services is good performance. Good performance is multidimensional… Decisions as to what, how much and how to produce should be efficient in two respects: Scarce resources should not be wasted, and production decisions should be responsive qualitatively and quantitatively to consumer demands.

look are pricing, quality and profits. Pricing and profits address both efficiency and fairness. They are the most direct measure of how society's wealth is being allocated and distributed.

The performance of industries is determined by a number of factors, most directly the conduct of market participants. Do they compete? What legal tactics do they employ? How do they advertise and price their products? [33] The fact that conduct is only part of the overall analytic paradigm is important to keep in mind.

Conduct is primarily a product of other factors. Conduct is affected and circumscribed by market structure. Market structure includes an analysis of the number and size of the firms in the industry, their cost characteristics and barriers to entry, as well as the basic conditions of supply and demand.[34]

Regardless of how much weight one gives to the causal assumptions of the paradigm, giving more or less weight to basic conditions or market structure, the list of variables is important. These are the factors that make markets work.[35]

> The operations of producers should be progressive, taking advantage of opportunities opened up by science and technology to increase output per unit of input and to provide consumers with superior new products, in both ways contributing to the long-run growth of real income per person. The operation of producers should facilitate stable full employment of resources… The distribution of income should be equitable. Equity is notoriously difficult to define, but it implies at least that producers do not secure rewards in excess of what is needed to call forth the amount of services supplied.

[33] Scherer and Ross, p. 4.

> Performance in particular industries or markets is said to depend upon the conduct of sellers and buyers in such matters as pricing policies and practices, overt and taciturn interfirm cooperation, product line and advertising strategies, research and development commitments, investment in production facilities, legal tactics (e. g. enforcing patent rights), and so on.

[34] Scherer and Ross, p. 5.

> Conduct depends in turn upon the structure of the relevant market, embracing such features as the number and size distribution of buyers and sellers, the degree of physical or subjective differentiation prevailing among competing seller's products, the presence or absence of barriers to entry of new firms, the ratio of fixed to total costs in the short run for a typical firm, the degree to which firms are vertically integrated from raw material production to retail distribution and the amount of diversity or conglomerateness characterizing individual firms' product lines.
> Market structure and conduct are also influenced by various basic conditions. For example, on the supply side, basic conditions include the location and ownership of essential raw materials; the characteristics of the available technology (e.g. batch versus continuous process productions or high versus low elasticity of input substitution); the degree of work force unionization; the durability of the product; the time pattern of production (e.g. whether goods are produced to order or delivered from inventory); the value/weight characteristics of the product an so on. A list of significant basic conditions on the demand side must include at least the price elasticity of demand at various prices; the availability of (and cross elasticity of demand for) substitute products; the rate of growth and variability over time of demand; the method employed by buyers in purchasing (e.g. acceptance of list prices as given versus solicitation of sealed bids versus haggling); and the marketing characteristics of the product sold (e.g. specialty versus convenience shopping method).

[35] Scherer and Ross, p. 6.

II. B. STRUCTURE

For the vast majority of the history of the automobile industry, vertical restrictions were voluntary. Manufactures and dealers agreed to the restrictions as a matter of contract. In the last quarter of the twentieth century, however, many of the restrictions were imposed by law.

When a producer agrees to restrict the number of dealers who can sell his product in an area (territorial exclusion or restriction), or a dealer agrees to not sell a product below a specified price (resale price maintenance), concerns about anticompetitive restraints on trade immediately arise. While a variety of justifications have been offered for these vertical restraints, consumer advocates have always been leery of them, particularly when they are imposed by statute. [36] The review of the nature and impact of vertical restraints on automobile dealerships shows that these concerns are well-founded.

II. B. 1. Voluntary Agreements As a Solution to Market Structure Problems

The primary economic justification for voluntarily entering into arrangements to establish exclusive territories or restrict entry rests on the belief that the distribution of certain commodities requires significant local support networks. Without some reasonable assurances about a market for their services, middlemen will not make the necessary investment in the local network or make the necessary outlay on advertising and service to support the product. The manufacturer needs middlemen to make the product attractive to consumers. The middlemen need assurances that their market will not be constantly under attack by new dealers or their services will not be "stolen" by free riders to make the necessary investment in local facilities. In the automobile industry, where local dealerships involve substantial capital invested in local assets, it can also be argued that establishing franchise relationships helps to raise capital and spreads risk.

Scherer and Ross describe the benefits of territorial exclusion generally claimed in the literature as follows:

> For the dealer, exclusivity is attractive because, by lessening competition, it permits wider price-wholesale, cost margins than could be sustained under an unrestricted access policy. From the manufacturers perspective, the wider margins encourage dealers to carry larger inventories and spend more money on advertising and other promotional activities. The dealer with a profitable franchise may be better able, and more willing, to provide high-quality maintenance and repair services.[37]

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[36] A similar effort to impose vertical restraints by federal statute on beer sales in the 1980s was vigorously resisted by consumer advocates (see Cooper, Mark N., *The Cost to Consumers of* Exclusive *Franchising: The Case of Malt Beverages,* consumer Federation of America, September 17, 1986). The subsequent economic literature has thoroughly supported the conclusion that these restraints are not in the consumer interest (see Culbertson, Patton, W. and David Bradford, "The Price of Beer: Some Evidence from Interstate Comparisons," *International Journal of Industrial Organization* , 1991).

[37] Scherer and Ross, p. 558.

Smith, in the first major, empirically-based critique of state imposed restrictions on automobile distribution offered a similar description of the presumed benefits of vertical restraints in the automobile industry.

> To ensure an optimal (from the perspective of the manufacturer) selling effort on the part of the dealer and to induce the dealer to provide a level of warranty service which may be too high from the perspective of the dealer, the manufacturer under the franchise system must guarantee that the extra investments in sales and service facilities would not be injurious to the dealer. That is, the dealer must be compensated for providing sales and service beyond the level he would voluntarily and independently choose to supply.[38]

In the automobile industry, Scherer and Ross point out that there are "network" effects that appear to have been important in creating a viable market in the early years of the industry.

> Most consumers are unwilling to buy a particular new automobile or computer unless they are confident they can obtain prompt, reliable service not only at home, but wherever they may travel or relocate. This can give the manufacturer with a far flung, high quality dealer network a sales advantage, although whether it actually does so depends upon how distribution channels are organized. There are economies of scale at the sales and service establishment level. A certain minimum investment in training, specialized testing equipment, and spare parts is necessary.[39]

II. B. 2. Voluntary Agreements As Market Structure Problems

There is another view of the vertical restraint, however. After reviewing the assumptions under which vertical restraints are defended, Scherer and Ross remain skeptical as a general matter.[40]

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[38] Smith, Richard L. II, "Franchise Regulation: An Economic Analysis of State Restrictions on Automobile Distribution," *Journal of Law and Economics*, XXV, 1982.

[39] Scherer and Ross, pp. 136-137.

[40] Scherer and Ross frame their main analytic discussion of vertical restraints in terms of resale price maintenance, but point out that

> a practice with many similarities to resale price maintenance is the granting by manufacturers of exclusive franchises to their dealers… For consumers, the benefits and costs of exclusive franchising and dealing are qualitatively similar to those what must be evaluated in judging resale price maintenance. (pp. 558-559).

Lin, Ping, et al, "The US Antitrust System and Recent Trends in Antitrust Enforcement," *Journal of Economic Surveys*, 14, 2000, offer a similar observation.

> Exclusive territories refer to the agreement between the supplier and the dealer that the supplier will not allow any other dealer to locate within a certain area – thereby making the dealer a local monopoly. Offering exclusive territories may help reduce the above-mentioned 'free-riding' problem. Also a potential social benefit of territorial restriction is that the distribution cost may be lowered by enabling each dealer to obtain scale economies. The potentially anticompetitive effect of exclusive territories are similar to RPM – it gives dealers more local monopoly power, thereby hurting consumers.

> In sum, we have examined in broad terms the motivation for, and consequences of, vertical restraints, discovering in the purest cases, those restraints can be either welfare-enhancing or welfare reducing, depending upon circumstances. Under plausible conditions, a tendency toward welfare reduction seems more likely than the opposite.[41]

> An important part of the "good" purchased by a new car buyer consists of service supplied by the dealer. In effect, this good may be conceptually partitioned into two components jointly demanded (and paid for) by consumers. The first is the "car" supplied by the manufacturer. The second consists of various ancillary sales services provided by the dealer, including adequate showrooms, sales personnel, information (e.g. local advertis ing), and a selection (i.e., an inventory of new cars). These services are made artificially scarce by the restrictive laws. The resulting monopoly rents then are collected by the dealer through higher car prices.[42]

Scherer and Ross question whether the vertical restraint ever was useful. They explicitly question two of the specific mechanisms most frequently offered in defense of exclusive franchises, the supply of information and inventory.

> Consumers with high… reservation prices presumably know enough about the product that they are eager to purchase it even without information provided by the dealer. If so, we should expect additional information services to enhance their willingness to pay by less than it does for consumers on the margin between buying and not buying… The extra information is of greater value to marginal consumers than to the more confirmed inframarginal buyers. In effect, the uniform elevation of prices… makes inframarginal consumers pay a premium for something of little value to them. Alternatively, if the service is retailer's willingness to carry abundant inventories, one might expect consumers with high reservation prices, to trade off some of their consumer surplus by incurring the cost of back-order delay, and/or additional shop visits, if the product they want is out of stock..[43]

In fact, with respect to information, the vertical restraint may make the consumer's job more difficult.

> When exclusive franchises are parceled out selectively, the consumer visiting any given retail outlet is confronted with a severely limited array of products, making side-by-side price and quality comparison difficult.[44]

> Another way in which entry regulation affects car prices is by its adverse impact on consumer search costs. The market for a costly multi-attribute good such as an automobile is characterized by a relatively high demand for information relevant to the

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[41] Scherer and Ross, p. 547.
[42] Eckard, E.W. Jr., "The Effects of State Automobile Dealer Entry Regulation on New Car Prices," *Economic Inquiry*, XXIV, April 1985, p. 226.
[43] Scherer and Ross, p. 548.
[44] Scherer and Ross, p. 560.

> purchase decision. A substantial portion of information is "self-supplied" by consumers through their own search efforts, i.e. an implicit supply schedule exists depicting the marginal costs of generating various levels of information... If entry regulation results in fewer dealers than would exist otherwise, then the marginal costs of obtaining various levels of information are greater, i.e., the supply curve shifts up.[45]

In sum, the restraints on trade help those least who need it most. It restricts availability of services and increases transaction costs (search for information, interaction with dealers, travel for repairs). Scherer and Ross point out that the benefits of the vertical restraints in the automobile industry probably were overstated throughout and they may well have been exhausted by the 1970s.

> If sales and service outlets are limited to the products of a single manufacturer, for example, through franchise contracts, low-volume manufacturers may be able to maintain efficient outlets only in larger cities...
>
> However, the advantage of larger auto firms depended critically upon dealer exclusivity – that is, on a given dealer handling only the products of one manufacturer. As the tendency toward exclusivity broke down during the 1970s and 1980s, in part because foreign automakers supplied superior-quality small cars desired by dealers to round out their lines, the disadvantages of small national volume waned...
>
> Through successful product differentiation, smaller firms may be able to carve out for themselves a small but profitable niche in some special segment of the market.

In fact, Eckard argues that, over time, the vertical restraint undoes exactly the function it was intended to support.

> Consider the effects of the regulation on a typical metropolitan area. Assume at the time of enactment of the relevant law an optimum number of new car dealers exists, i.e. resources allocated to providing sales services are earning a normal return and consumer purchase costs are minimized. Assume next that as time passes the demand for new cars in this area increases, implying an increase in the derived demand for ancillary services. Quasi-rents therefore appear for resources currently allocated to supplying these services. Absent the law, these short-run effects would attract entry (i.e., a new dealer) and the quasi-rents would thereby be dissipated. However, if extant dealers are successful in using the law to block entry, then the rents become permanent. In sum, given an outward shift of the (downward sloping) demand curve for sales services, competition among consumers causes the price of these services to be bid up which in turn leads directly to an increase in the new car transaction price. With new entry barred, these price increases become permanent.[46]

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[45] Eckard, pp. 227-228.

[46] Eckard, E.W. Jr., "The Effects of State Automobile Dealer Entry Regulation on New Car Prices," *Economic Inquiry*, XXIV, April 1985, pp. 227-228.

II. B. 3. Conclusion

With the broad economic structural arguments stripped away, the battle over restrictions on entry and exit focus on the relative bargaining power of dealers and manufacturers. As noted in the debate in Texas, the center of the debate is the conflict between in-state dealers and large national corporations. A description of the arguments on both sides of this issue in the mid-1980s was provided by the American Bar Association.[47]

The argument for restrictions is that unsophisticated dealers have imperfect access to capital[48] that is tied up in highly specific assets.[49] They are at a disadvantage when confronting large national companies that control the trademark, account for the majority of marketing and allocate the product.[50] As a consequence, they are vulnerable to being "held-up" by manufacturers, once they build a business.[51]

The counter argument is that the dealers are hardly babes in the woods, generally being large businesses with legal representation.[52] Their assets are, in fact, reasonably mobile.[53] They can exit on fair economic terms,[54] particularly since the manufacturers have neither the interest[55] nor the ability to terminate well-run dealerships arbitrarily under contract law.[56]

Not unexpectedly, it was during the 1970s, when the overall automobile market changed dramatically, that the vertical restraint laws applying to the automobile dealerships were enacted. It is interesting to note that many analysts see the primary benefit of the increased use of the Internet in the automobile supply chain as enhancing the flow of information and saving on inventory costs by expanding the possibility of manufacture to order sales. In other words, the most egregious harms of the vertical restraint are addressed by the new marketing practice. Put another way, new economic forces are attacking the vertical restraint at it most vulnerable point, its claimed historical economic justification.

In summary, it is highly unlikely that vertical territorial restraints are a solution to a structural problem in today's market. It is much more likely that they have become a structural problem themselves.

II. C. CONDUCT

When the economic basis for the voluntary vertical restraint was eroded, dealers resorted to political activity to preserve an institution that had outlived it usefulness. Smith

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47 American Bar Association, Section of Antitrust Law, *Franchise Protection: Laws Against Termination and the Establishment of Additional Franchises*, 1990.
48 Ibid., p. 28.
49 Ibid., p. 42.
50 Ibid., p. 112.
51 Ibid., p. 39-40.
52 Ibid., p. 30-32.
53 Ibid., p. 106.
54 Ibid., p. 50.
55 Ibid., pp. 36-37.
56 Ibid., pp. 32-36.

summarizes the transformation of what may have been a positive economic institution from the consumer point of view into a negative one as follows:

> It is true that, under the original franchise provisions, appropriation of the dealer's investment by the manufacturer was possible, but such appropriation was extremely unlikely given the manufacturer's interest in maintaining an effective distribution network. The economic justification for regulation, that there is some third-party effect which is not taken into account in private transactions, does not appear to apply in the case of manufacturer-dealer regulation. Rather, the intent of the regulation appears to be to shelter the small-business owner from potential injustice by the manufacturer. However, the preceding analysis suggests that the regulations, in some cases, go beyond paternalism to the point of creating monopoly power for the dealers...

The central conduct issue in the statute-based vertical restraints are political effort to impose restraints.[57] Several analysts note that whatever the benefits of the institution at a given point of time, the vesting of interest in that institution elicits political action to preserve it.

> Once territorial assignments are made, the dealers often consider their exclusive domain to be a valuable property right, and changes are vigorously opposed.[58]

> The only avenue remaining to manufacturers is the same political process that dealers have used with so much success. A question beyond the scope of this paper is why dealers have been so politically effective and manufacturers have not. The answer appears to depend both on interest-group efficacy and the size of the potential gain from political action. The simple reversing of the impact of existing regulations does not appear to mean that manufacturers would stand to gain very much, since the wealth transfer to dealers is, for the most part, at the expense of consumers... As to why consumers have tacitly permitted themselves to be taxed for the benefits of dealers, the answer must lie in the cost of learning about the transfer, and then organizing an effective political coalition to deal with it.[59]

With feeble economic justifications removed and private corporate interest arguments of equal strength on both side, immense political effort has been expended by the dealers to preserve their market power. The political efforts to legislate restrictions over the past several decades have resulted in extensive restriction on dealer markets. Exhibit 1 summarizes a recent survey of marketing restrictions in the automobile industry.

All jurisdictions license dealers (50) and almost all regulate warranty work (48). Almost all jurisdictions (48) regulate the termination of dealerships. Additional regulation of entry and exit are also pervasive including sale and transfer of dealerships (45) and establishment or

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[57] The recourse to legislation to protect economic interest through vertical restraints is a frequent theme. For example, see Economides, Nicholas, Glenn Hubbard and Darius Palia, "The Political Economy of Branching Restrictions and Deposit Insurance: A Model of Monopolistic Competition among Small and Large Banks," *Journal of Law and Economics*, October 1996.

[58] Scherer and Ross, p. 559.

[59] Smith, p. 54.

EXHIBIT 1:

PREVALENCE OF VERTICAL RESTRICTIONS ON AUTOMOBILE DISTRIBUTION

PRACTICE	NUMBER OF JURISDICTIONS
GENERAL	
LICENSING	50
WARRANTY WORK	48
ENTRY AND EXIT	
FRANCHISE TERMINATION	48
ESTABLISH/REESTABLISH	41
SALE/TRANSFER	45
REPURCHASE	38
SUCCESSION	35
MANUFACTURER DEALERSHIP BAN	31
LOCATION CHANGE	14
TERRITORIAL RESTRICTION	
RELEVANT MARKET AREA	41
EXCLUSIVITY	32
MANUFACTURER DEALER RELATIONS	
VEHICLE DISTRIBUTION	42
ENHANCED DAMAGES	38
ARBITRATION	34
PRICE DISCRIMINATION	22
CONFIDENTIAL INFORMATION	12
PRESALE DAMAGES	12
DEALER OPERATION	
EXECUTIVE MANAGEMENT	14
ADVERTISING	13

Source: Virginia Department of Motor Vehicles and the Virginia Motor Vehicle Dealer Board, *An Analysis of the Economic Implications of Manufacturer Owned Motor Vehicle Dealerships,* 1999.

relocation of dealerships (41). Restrictions on territory (41) and exclusivity (32) are also popular. Explic it prohibitions on manufacturer owned dealerships (MOD) are also prevalent (31).

Many states also regulate the business relationship between manufacturers and dealers. Regulation of allocation of cars is quite common (42). Regulation of price discrimination against dealers is found in just under half the jurisdictions (22).

Regulations are frequently enforced with arbitration requirements (34) and enhanced damages (38). In a smaller number of cases (about a dozen) regulation applies to management, advertising and other aspects of the operation of the dealership.The rapid spread of entry restrictions is also notable (see Exhibit 2). The first such restriction was adopted in 1965. In 1970, only two states restricted entry. By 1983, three dozen states had adopted these restrictions. Today the number is 41. Moreover, as we describe below, the nature of the restrictions is being extended to cover more aspects of entry.[60]

II. D. PERFORMANCE

Whatever the justifications for vertical restraints in the past, the correct public policy depends on what is actually happening in the marketplace at present. As the marketplace changes, justifications need to be reexamined. Practices that made sense at one point in time may no longer serve their original purposes. Whatever their original intent, in the face of the ongoing changes in the automobile market do the restraints on entry raise prices?

Would vertical integration harm consumers? Would they dominate the distribution system and have or exercise market power?

Would a change in public policy have an impact on the consumer that would be large enough to justify the substantial efforts that are necessary to change public policy?

By and large, the answers to these questions provide little support for restrictions on entry into the dealer market or on direct sale to consumers by manufacturers and others.

II. D. 1. Empirical Studies of the Impact of Vertical Restraints

Empirical studies and regulatory reviews of territorial restraints on distribution have consistently found that they result in higher prices to consumers. While these studies are somewhat dated, all having been conducted in the 1980s, the results are uniform (see Exhibit 3). Generally relying on comparisons between areas with and without restrictions, the result is a markup of about 6-8 percent in markets where restrictions are in force. At today's prices of $25,000, that would yield potential cost savings to consumers in the range of $1500 to $2,000 per vehicle in areas with restriction.

[60] Harris, Donna, "Dealers Halt Threat from Factory Stores," *Automotive News*, November 6, 2000.

EXHIBIT 2:
NUMBER OF STATES WITH
TERRITORIAL RESTRICTIONS

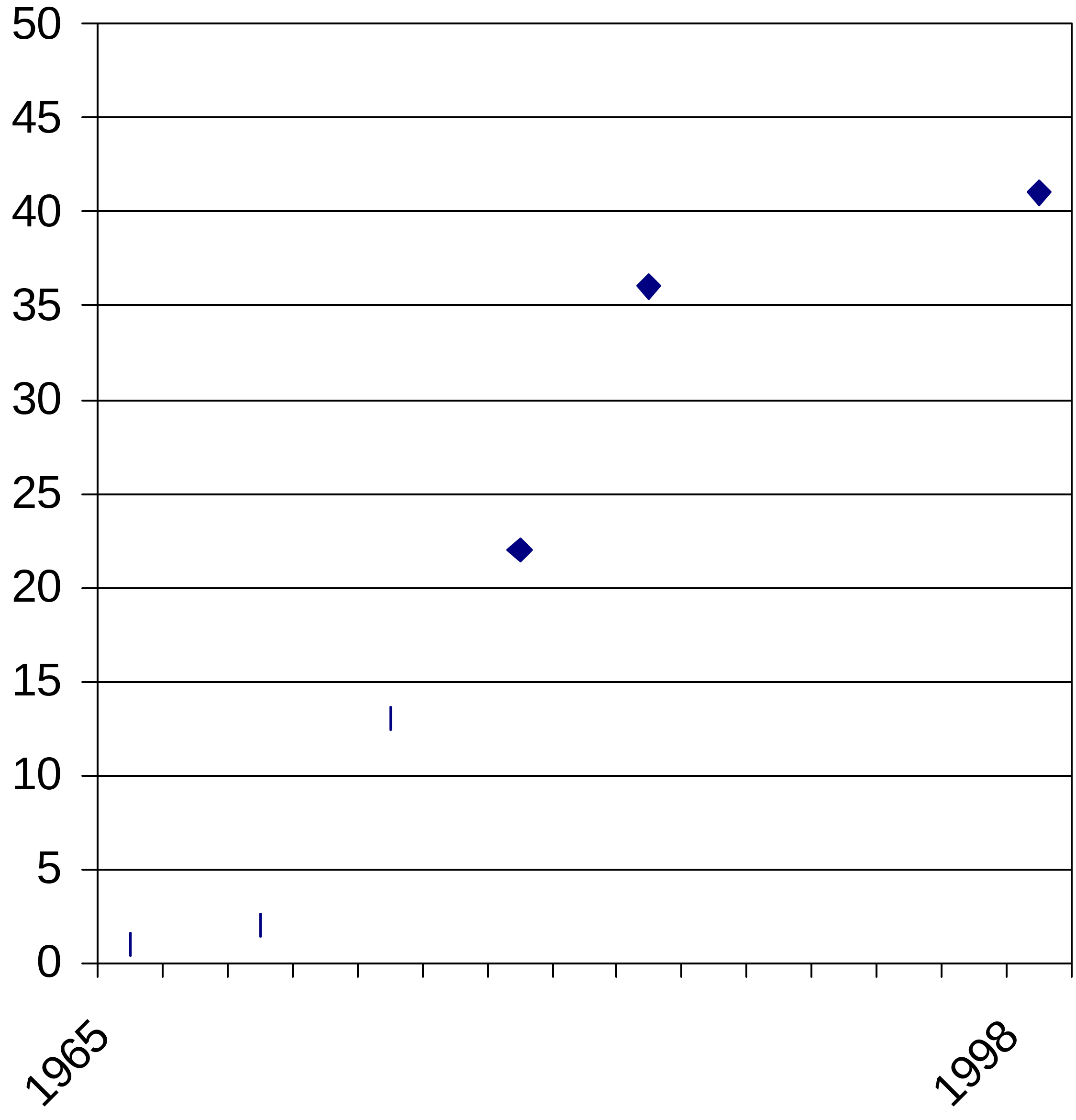

EXHIBIT 3

ANALYSES CONCLUDING THAT VERTICAL RESTRICTIONS ON AUTOMOBILE DEALERSHIPS HARM THE PUBLIC

STUDY	TYPE	DATE	
Ohio	Regulator	Qualitative	1979[61]
National	Academic	Econometric	1980[62]
National	Academic	Econometric	1982[63]
National	Academic	Econometric	1985[64]
National	Regulator	Econometric	1986[65]
Hawaii	Regulator	Qualitative	1986[66]
Florida	Regulator	Qualitative	1986[67]
Tennessee	Regulator	Qualitative	1986[68]
Texas	Regulator	Qualitative	1991[69]
Florida	Regulator	Qualitative	1996[70]
Virginia	Regulator	Qualitative	1999[71]
National	Academic	Econometric	2000[72]
Europe	Regulator	Qualitative	2000[73]

[61] Ohio Attorney General, *Comments on Ohio S.B. No. 206*, 1979.

[62] Brown, G. M., "State Motor Vehicle Franchise Legislation: A Survey and Due Process Challenge to Board Composition," *Vanderbilt Law Review*, 1980.

[63] Smith, "Franchise Regulation: An Economic Analysis of State Restrictions on Automobile Distribution," *Journal of Law and Economics*, 1982.

[64] Eckard, E.W. Jr., "The Effects of State Automobile Dealer Entry Regulation on New Car Prices," *Economic Inquiry*, 1985.

[65] Bureau of Economics, Federal Trade Commission, *The Effect of State Entry Regulation on Retail Automobile Markets*, 1986.

[66] Legislative Auditor of the State of Hawaii, *Sunset Evaluation Report: Motor Vehicle Industry Licensing*, 1986.

[67] Florida Office of the Auditor General, *Performance Audit of the Motor Vehicle Dealer and Manufacturer, Factory Branch, Distributor and Importer Licensing Programs Administered by the Department of Highway Safety and Motor Vehicles*, 1986.

[68] Comptroller of the Treasury, *Tennessee Motor Vehicle Commission*, 1986.

[69] Texas Sunset Advisory Commission, *Texas Motor Vehicle Commission*, *1991*.

[70] Office of Program Policy Analysis and Government Accountability, *Review of the Automobile Manufacturer Licensing Program*, 1996.

[71] Virginia Department of Motor Vehicles and the Virginia Motor Vehicle Dealer Board, *An Analysis of the Economic Implications of Manufacturer Owned Motor Vehicle Dealerships*, 1999.

[72] Morton, Fiona Scott and Florian Zettelmeyer and Jorge Silva Risso, Internet Car Retailing (September 2000.

[73] European Commission, *Report of the Evaluation of Regulation (EC) No. 1475/95 on the Application of Article 85(3) of the Treaty to Certain Categories of Motor Vehicle Distribution and Servicing Agreements* (Brussels, 2000).

In the first study of the impact of restraints of automobile dealerships, Smith observed both a reduction in the number of dealerships and an increase in the price of autos, which he linked to reductions in sales.

> They appear to be protected from entry of new dealerships, from discipline by the manufacturer, and from involuntary termination. The net effect is fewer dealerships and increased market power resulting in higher prices. The impact appears to be mitigated somewhat by increased scale economies arising from restricted entry…
>
> Results are consistent with the hypothesis that state regulation has enhanced the ability of dealers to restrict new entry and has protected them from involuntary termination. Over all states, the average impact of regulation from 1954 to 1972 appears to be a 15.3 percent reduction in the number of new car dealers….
> The average price increase across states due to REGS… is 524 (1972 dollars) or 9.3 percent of the average observed price. When the estimated price elasticity is used, this corresponds to a 1.065 million unit reduction in output or 8.3 percent of actual 1972 sales.
>
> The analysis suggests that state regulation of manufacturer-dealer relations in automobile franchising has tended to strengthen the locational market power of dealers and to deprive manufacturers of feasible means of disciplining dealers. The result has been a significant increase in vehicle prices – resulting in a large wealth transfer from consumers to dealers and a reduction in the volume of new-vehicle sales.[74]

Subsequent studies over the 1980s added considerable detail to these findings. Eckard added considerations of time and market growth to the analysis. The longer the laws are in effect and the faster the market is growing, the greater the impact was found to be.[75] Time and growth are important since it is the reduction of dealerships relative to the market that enhances market power.

A Federal Trade Commission study reinforced these findings.

> In areas where population had increased since the passage of an RMA law, our estimate of the effect of the RMA laws had on the average price of a new Chevrolet range from 3.68 percent for the Sportvan to 16.82 percent for the Corvette. We estimate that the RMA laws caused the average price across all nine models to increase by 7.63 percent. Averaging across all areas, including those with zero or negative population growth, the estimated average price effects range from 2.22

[74] Smith, pp. 150… 154.
[75] Eckard, Rogers.

percent for the Sportvan to 13.82 percent for the Corvette, with an average across all models of 6.14 percent.[76]

Recognizing that the FTC findings posed a blow to the claim that the vertical restrictions did not harm consumers, the dealers commissioned a critique of the FTC study.[77] The FTC respecified its analysis in response and added a key finding that dealer margins were increased as a result of entry restrictions.[78]

Empirical econometric evidence clearly supports the conclusion that restrictions on entry harms consumers. It reduces the number of dealers creating local market power for the protected dealers. This results in higher margins for dealers and higher prices for consumers. The longer the restrictions are have been in place and the faster the market is growing, the larger the effect of the restrictions.

II. D. 2. Empirical Studies of Reducing Vertical Friction in the Market

Although studies of vertical restraints on automobile dealerships stopped in the early 1980s, studies of Internet sales of automobiles have begun and these tend to support the conclusions of the earlier analysis from the opposite direction. That is, the early studies showed that restrictions on entry hurt consumers. The contemporary studies indicate that entry of new marketers and new marketing methods helps consumers.

In a detailed econometric study of transaction data, an academic study of the impact of Internet shopping for automobiles found a pattern of impacts that mirror those of the earlier studies of vertical restraints.

> Conditional on the car, consumers that submitted a purchase request pay on average $451 less than an offline customer. Of these savings $72 stem from the fact that Autibytel.com steers customers to low-price dealerships. Conditioning on the dealership (in addition to the car), online consumers pay another $379 less than offline customer. We also find that the level of price dispersion at a dealer declines in the dealer's Autobytel.com business. This indicates that the lower prices we find are not entirely driven by the selection effect (good bargainers move online). The combination of results and the fact that referral services save consumers time seem to validate Autobytel.com's value proposition to consumers (and perhaps that of other referral services) and may explain why referral service usage has grown rapidly.
>
> Secondly, we examine the level of dealer profits from the vehicle and from other products and services sold using the web. Dealer margins (price less invoice) on the sale of a vehicle through Autobytel.com are significantly lower than margins earned

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[76] Rogers, PP. 7-8.

[77] Wharton Econometric Forecasting Associates, Inc., *An Evaluation of the FTC's Analysis of the Effects of RMA Laws on Auto Markets*, January 1987.

[78] Bureaus of Competition, Consumer Protection and Economics, Federal Trade Commission, *Response to Wharton Econometric Forecasting Associates Comments on the Bureau of Economics Study of Relevant Market Area Laws*, in American Bar Association, Section of Antitrust Law, *Franchise Protection: Laws Against Termination and the Establishment of Additional Franchises*, 1990.

> selling the vehicle the traditional way; prices are lower and the costs of acquiring the vehicle are not. In addition, profits from ancillary products like financing and service contracts are lower (by about $160) when the customer arrives via the web. Because online customers are substantially cheaper to serve, however, the dealer is likely to be better off working with Autobytel.com.[79]

These estimated savings represent only the start of the process of squeezing out pricing abuse, since the online marketers are still working around restrictive laws, forced to go through dealers, and efficiencies of build-to-order cannot yet be captured. Nevertheless, the parallel between the earlier analyses of vertical restraints and the current analysis of Internet shopping could not be stronger. Each of the key points – price, margin and cost – is supported. The savings that have already been achieved are substantial and support the possibility of much larger savings, should direct selling spread through the distribution chain.

II. D. 3. Regulatory Reviews of Entry Regulation

Policy reviews have been at least as frequent as econometric analyses. For example, after reviewing the regulation of entry and exit and the imposition of territorial restrictions, a 1996 Florida Legislative study concluded that "Programs like Florida's may reduce competition and increase consumer cost."[80] It was skeptical of the claim that the program was necessary to defend dealer interests.

> The primary advantage of retaining the program is that it may serve to level the playing field between manufacturers and dealers, which could otherwise be unbalanced in the manufacturer's favor. Although it is questionable whether or to what extent manufacturers would undermine dealer networks because they need viable franchises to sell the products, manufacturers could use their economic power to make business decisions over dealer objections without legal controls.[81]

The Florida study clearly recognized that consumer interests were not promoted by the dealer protection programs, although it recognized that dealers would resist the changes and that short term disruptions would occur.

> Reducing regulation of the manufacturer-dealer relationship may cause temporary disruptions in the industry in Florida, but such changes likely will ultimately benefit consumers.[82]

The Florida study notes that "Four states – Hawaii, Florida, Tennessee and Texas – have conducted reviews of their automobile manufacturer programs. Each study concluded that the programs restrain trade and recommended that they be modified or eliminated."[83]

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[79] Morton, et al., p. 3.
[80] Office of Program Policy Analysis and Government Accountability, *Review of the Automobile Manufacturer Licensing Program*, February 29, 1996, p. 1.
[81] Ibid., p. 10.
[82] Bid, p. 11.

A more recent consideration of the narrow question of manufacturer owned dealerships (MOD) as opposed to a general reduction on restraints on dealerships, conducted by the state of Virginia concludes that

> the impact on the consumer of the actual competitive outcome from vertical integration will depend upon the specifics of a particular market structure, the demand conditions in a market, the new cost structure facing the integrated manufacturer-dealer and the retailing practices used in the market.[84]

While a negative outcome is possible, the report gives the clear impression that the circumstances under which consumers would be worse off are not likely.

> Lower Prices After Consolidation
>
> Given the existence of economies of scale and expected efficiencies gains through better control of the marketing channel, average vehicle price could decline and the average consumer could be made better off.[85]

The Virginia report reaches the conclusion that increases in average prices are not in the manufacturer's interest, unless they are associated with perceived increases in quality.

> Higher Prices After Consolidation
>
> The existence of some degree of monopoly power gained through consolidation of competing dealerships and/or the increased cost of operations would suggest that price could increase and the consumer could be made worse off. However, we maintain that any vehicle manufacturer does not wish to decrease sales and, therefore, these conditions are not sufficient for their to be an increase in average price. We feel that there are two possible outcomes in which average vehicle price might increase and sales not necessarily decrease. In one situation, the average consumer is, in fact, made better off. In the other, the average consumer is made worse off.[86]

The Virginia report identifies a number of quality enhancements to the buying process that, even if associated with a higher price, could result in a net gain for the consumer.

> If the MOD can make the consumer better off, either in reality or in the consumer's perception, demand for its product will increase and price can be increased without a decrease in sales. In this situation the average consumer must be considered to be

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[83] Ibid., p. 7, citing "Legislative Auditor of the State of Hawaii, *Sunset Evaluation Report: Motor Vehicle Industry Licensing* (1986); Florida Office of Attorney General, *Performance Audit of Motor Vehicle Dealer and Manufacturer, Factory Branch, Distributor, and Importer Licensing Programs Administered by the Department of Highway Safety and Motor Vehicles* (1986); Comptroller of the Treasury, *Tennessee Motor Vehicle Commission* (1986); Texas Sunset Advisory Commission, *Texas Motor Vehicle Commission* (1991).

[84] Virginia Department of Motor Vehicles and the Virginia Motor Vehicle Dealer Board, *An Analysis of the Economic Implications of Manufacturer Owned Motor Vehicle Dealerships*, 1999,

[85] Ibid., p. 14.

[86] Ibid., p. 15,

> better off since they are paying a higher price for what they perceive to be a set of characteristics that make for a better product. Such characteristics include the bundle of dealership services and/or the consumer buying experience; larger selections of vehicles from consolidated inventories; changes in retailing practices that include longer hours; and, the perceived benefit of buying "factory direct."[87]

The circumstance in which vertical integration could have a negative consequence is where market power is created through the elimination of intrabrand competition, but even here the report notes that other channels may be opened.

> As dealerships are consolidated in a MOD, there will be a decrease in intrabrand competition. In the limit, all dealerships in a metropolitan area are consolidated under the MOD and there would be no intra-brand competition in a region.[a] The decrease in intra-brand competition would suggest the demand facing the MOD would become relatively elastic. In this situation, the MOD, and perhaps any remaining franchised dealers, could find that demand conditions were such that the market could withstand an increase in average vehicle prices without a concomitant decrease in sales. In this situation, the consumer would be made worse off since they would be paying more for the same produce and services.
>
> [a] We note that this situation often exists in the market for many European luxury vehicles and that e-commerce is now providing some degree of competition to these dealers.[88]

We have already noted that some analysts see the effort to allow direct sales of autos as opening the door to wide ranging competition that the dealers could not control. The Virginia report also considers the possibility that consumers could feel they are worse off "from having what they might consider to be a decreased set of choices over dealers or business practices, it could also result from the desire not to do business with a national entity."[89]

III. THE IMPACT OF LIFTING RESTRAINTS

Although the evidence seems overwhelmingly in favor of removing the restrictions, legitimate questions remain, as suggested by the Virginia study.

III. A. MARKET POWER

The first set of questions relates to market power. Because the current existence of these restraints is driven by efforts by dealers to protect their interests, the dealers focus attention on the one outcome that could have negative consequences for consumers. If

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[87] Ibid., p. 15.
[88] Ibid., pp. 15-16.
[89] Ibid., p. 16.

allowed, would manufacturers vertically integrate into owning dealerships, increasing their market power, which would then be used to raise prices and/or reduce quality? The critical question is what is the chance that the increase in market power of manufacturers as a result of vertical integration into dealerships will be greater than the market power exercised by dealers operating with the vertical restraints in place?

III. A. 1. Intrabrand v. Interbrand Competition

An assessment of the balance between intrabrand and interbrand competition is critical to answer this question. If the market is driven by interbrand competition, the danger from the elimination of intrabrand competition is small. Moreover, the vigor of intrabrand competition under the current market structure with restraints and the ability of manufacturers to control intrabrand competition in a future market without restraints is questionable.

Is the driving force in the industry competition between Ford and Chevy (interbrand) or between Sheehy Ford and Koons Ford (intrabrand)? If the central axis of competition is between Ford and Chevy, it would not matter if Sheehy and Koons merged (or were put out of business by a manufacturer owned dealership or other distribution channels with lower costs), because their market power would be checked by the competition from Chevy. Ford needs to deliver the same price and quality to fend off Chevy.

If interbrand competition is not sufficient to discipline vertically integrated suppliers, then it could harm consumers, particularly in the realm of service quality. If Ford does not fear Chevy, it could dominate dealers and cut back on quality. Quality is the key because, if interbrand competition is not driving manufacturers, then they can always capture all of the available rents on the sale price of the automobile. They simply set the wholesale price to capture whatever monopoly rents are available. Dealers could still compete for service quality, which is a separate product. If they have a higher quality product to sell, they could become the higher volume operations (in a generally fixed volume market, since interbrand competition is unimportant). Dealers could raise their prices to achieve higher profits because they give better quality. Vertically integrated manufacturers not facing interbrand competition, could reduce quality because the same number of units would be sold even at lower levels of service quality.

It seems highly unlikely that intrabrand competition is driving the price/quality mix to the consumer. It probably has some impact on quality of service, although that may be shrinking. It appears to have very little impact on price. It also seems that interbrand competition has grown in importance. This conclusion is based on an analysis of the market structure and the behavior of manufacturers.

III. A. 2. Market Structure

The automobile market underwent a dramatic change in the last quarter of the twentieth century with a sharp increase in the number of brands and models sold and a decrease in market concentration. As a result, the market power of the leading firms has been dramatically reduced. At the same time, the quality of the product has improved dramatically, on average.

As a result, the role of the dealer in support services has been diminished. This process of increasing competition and greater quality has gone a long way toward "commoditizing" the automobile. There are a lot more firms selling products that are more standardized and durable in terms of service. Marketing has shifted to attempting to differentiate by features and extras – models and packages.

Recalling that the push for vertical restraints dates from the 1970s, we should ask what the structural conditions of interbrand competition are in the automobile market today, compared to then. Exhibit 4 presents measures of the increasing diversity of supply and the improving quality of service. The number of brands increased dramatically, while the percentage of the market supplied by domestic manufacturers declined. The amount of service required per vehicle declined sharply.

More detailed measures of competition are available. The measure used is the Hirschman-Herfindahl Index (HHI). Market structure analysis is used to identify situations where a small number of firms control a sufficiently large part of the market as to make coordinated or reinforcing activities feasible. Through various implicit and explicit mechanisms a small number of firms can reinforce each other's behavior, rather than compete. Identification of when a small number of firms can exercise this power is not a precise science. Generally, however, when the number of significant firms falls into the single digits, there is cause for concern, as the following suggests.

> Where is the line to be drawn between oligopoly and competition? At what number do we draw the line between few and many? In principle, competition applies when the number of competing firms is infinite; at the same time, the textbooks usually say that a market is competitive if the cross effects between firms are negligible. Up to six firms one has oligopoly, and with fifty firms or more of roughly equal size one has competition; however, for sizes in between it may be difficult to say. The answer is not a matter of principle but rather an empirical matter.[90]
>
> The clear danger of a market with a structure equivalent to only six equal sized firms was recognized by the Department of Justice in its Merger Guidelines.[91] These guidelines were defined in terms of the Herfindahl-Hirschman Index (HHI). This measure takes the market share of each firm squares it, sums the result and multiplies by 10,000.[92]

A market with six equal sized firms would have an HHI of 1667. The Department declared any market with an HHI above 1800 to be highly concentrated. Thus, the key threshold is at about the equivalent of six or fewer firms.

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[90] J. W. Friedman, Oligopoly Theory (Cambridge: Cambridge University Press, 1983), pp. 8-9.
[91] U.S. Department of Justice, Merger Guideline, revised, 1992.
[92] Shepherd, p. 389.

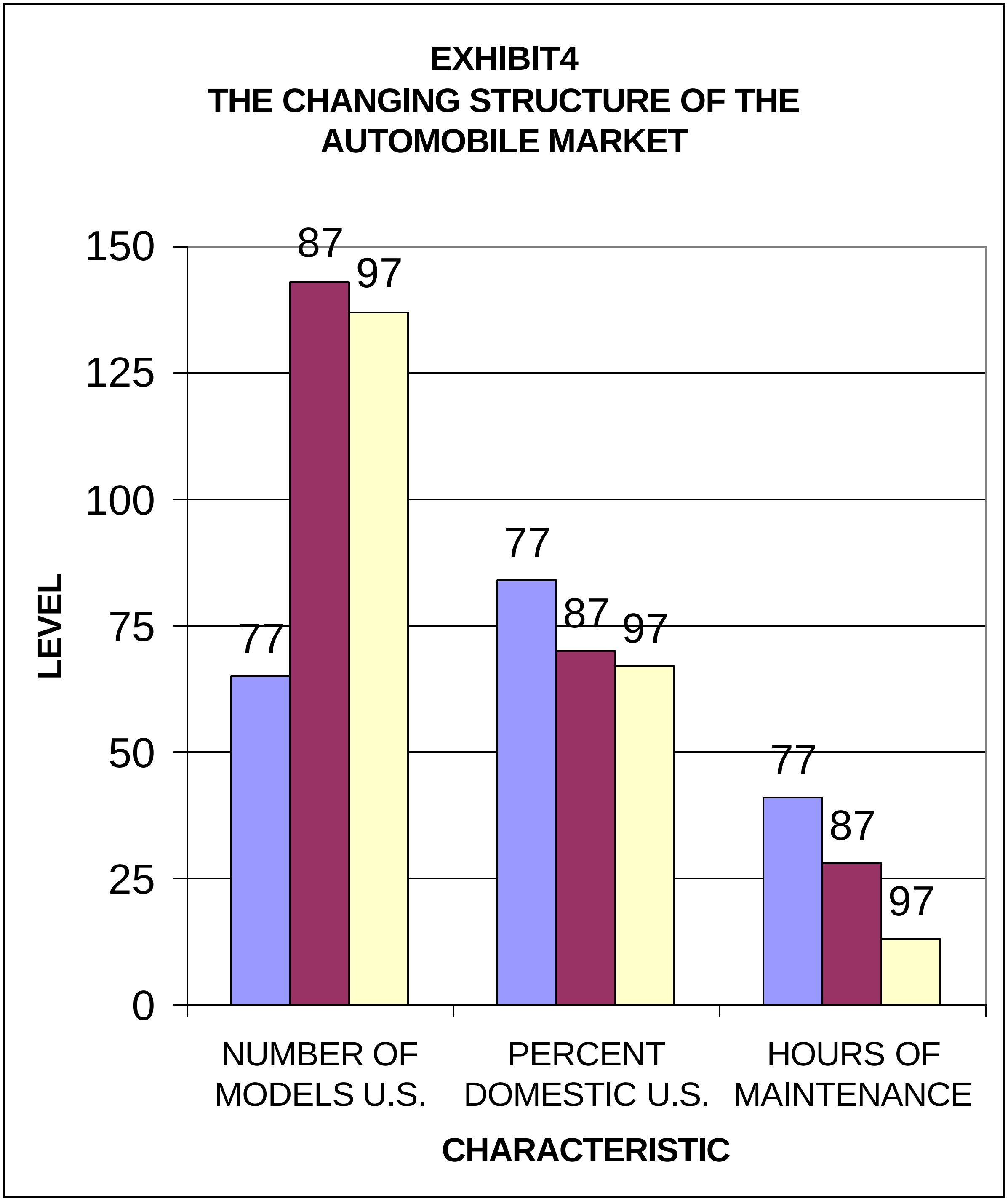
EXHIBIT4
THE CHANGING STRUCTURE OF THE
AUTOMOBILE MARKET
LEVEL
150
125
100
75
50
25
0
77
87
97
77
87
97
77
87
97
NUMBER OF
MODELS U.S.
PERCENT
DOMESTIC U.S.
HOURS OF
MAINTENANCE
CHARACTERISTIC

Exhibit 5 shows the degree of concentration in the national automobile market in 1967 and 1997. Measured at the level of companies – e.g. Ford, GM, Chrysler, Toyota, Honda, etc. – the HHI has declined dramatically in the past three decades. In 1967 it was close to 3000, a highly concentrated market. By 1997 it had declined to just under 1600, which falls in the moderately concentrated range, just below the threshold of the equivalent of six equal-sized competitors. Measured at the level of divisions or models, there are much lower levels of concentration.

If we include vans and sport utility vehicles in the analysis, since these represent new products that clearly occupy the passenger car space, the conclusion is altered only slightly. Because these product lines are more concentrated than the passenger car lines, the overall concentration in the passenger car market would be just at 1800. This is still a dramatic reduction from 1967.

In the three decades since the automobile dealers have successfully imposed vertical restraints, which have resulted in a substantial increase in their market power, manufacturers have experienced a sharp reduction in theirs. The automobile market remains moderately concentrated. From the point of view of this structural analysis, it is highly unlikely, however, that the market power the manufacturers could exercise through vertical integration is greater than the market power presently being exercised by dealers. This observation is reinforced be the behavior a variety of market participants.[93]

III. A. 3. Conduct

We have already noted the effort of a variety of entities to enter the automobiles distribution market, which have been frustrated by the statutes imposing vertical restraints. This suggests that there is little risk of an abuse of market power resulting from vertical integration.

More to the point, manufacturer behavior is also inconsistent with the notion that intrabrand competition is more important than interbrand competition. Exhibit 6 shows how marketing and distribution costs take up a substantial part of the manufacturer's suggested retail price (MSRP). These numbers indicate that interbrand competition is driving substantial costs to manufacturers.

First, dealer and manufacturer discounts below manufacturer suggested retail price to consumers are widely available and manufacturer discounts are far larger than dealer discounts. If interbrand competition were not driving manufacturers, manufacturers could stop both of these discounts and pocket the money. Manufacturer discounts (of about 6 percent of MSRP) are clearly given to move brands in competition with other brands. Manufacturers spend

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[93] An extensive literature on interbrand competition generally finds oligopolistic competition, with stronger competition in low cost models and for foreign manufacturers (Verboven, Frank, "Product Line Rivalry and Market Segmentation – With an Application to Automobile Optional Engine Pricing," The Journal of Industrial Economics, December 1999; Goldberg, Pinelopi Koujanou, "Product Differentiation and Oligopoly in International Markets: the Case of the U.S. Automobile Industry," Econometrics, 63, 1995; Berry, Steven, James Levinsohn, and Ariel Pakes, "Automobile Prices in Market Equilibrium," Econometrica, 63, 1995.

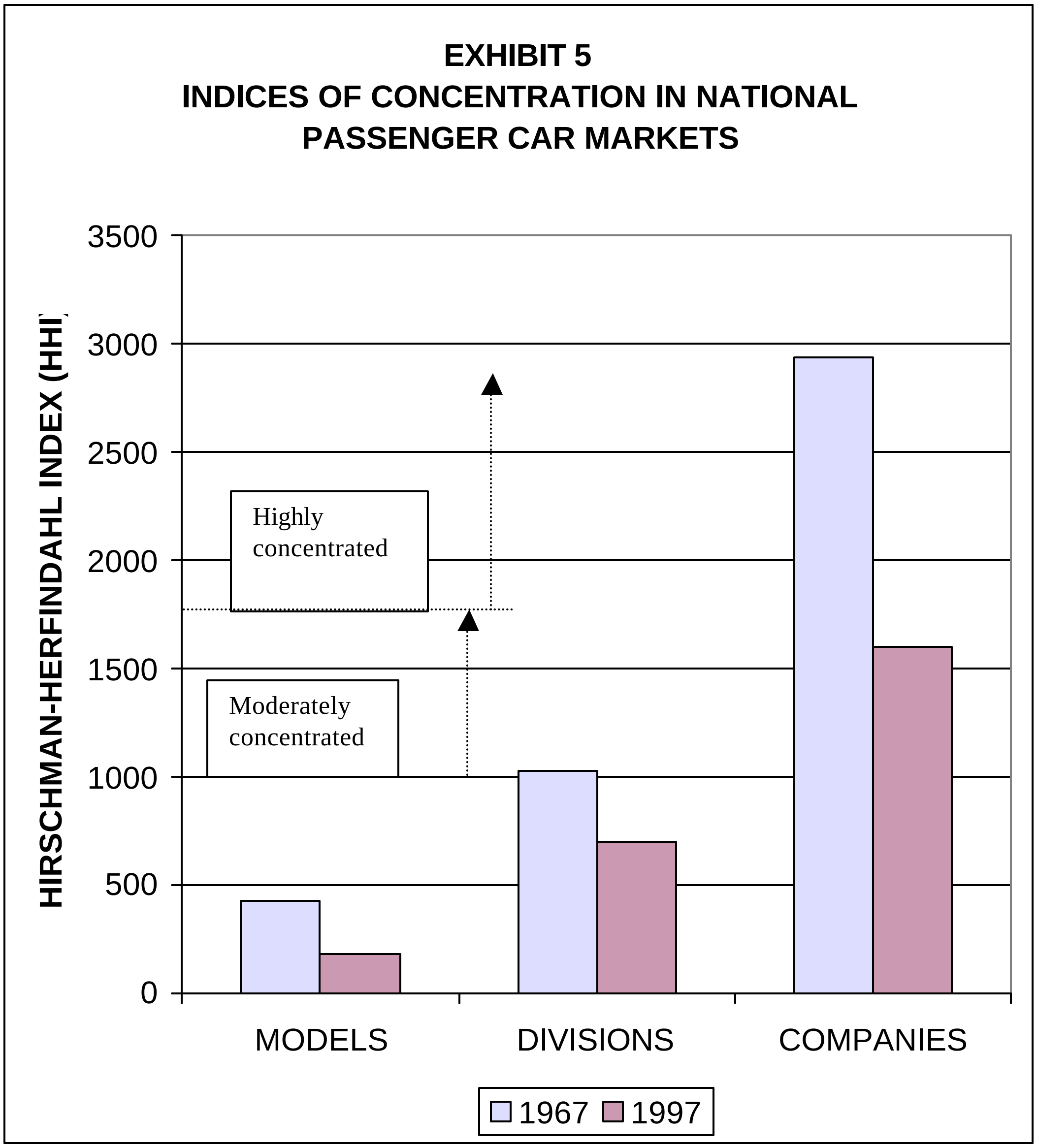
EXHIBIT 5
INDICES OF CONCENTRATION IN NATIONAL PASSENGER CAR MARKETS
HIRSCHMAN-HERFINDAHL INDEX (HHI)
3500
3000
2500
2000
1500
1000
500
0
Highly concentrated
Moderately concentrated
MODELS
DIVISIONS
COMPANIES
1967
1997

EXHIBIT 6
DISTRIBUTION COST OF AUTOMOBILES
AS A PERCENTAGE OF MANUFACTURER SUGGESTED RETAIL PRICE

TOTAL COST IN PRODUCTION		60
TOTAL COST IN DISTRIBUTION		40

BREAKDOWN BY SOURCE

Dealer Subtotal		30
Discount	3	
Interest	2	
Advertising	3	
Profit	2	
BMO Cost	20	
Manufacturer Subtotal		10
Discount	6	
Advertising	3	
Lease loss	1	

BREAKDOWN BY USE

CONSUMER GETS		10
Dealer Discount	3	
Manufacturer Discount	6	
Lease loss	1	
DISTRIBUTION CONSUMES		30
Dealer		27
Interest	2	
Advertising	3	
Profit	2	
BMO cost	20	
Manufacturer		3
Advertising	3	

SOURCES: These are order of magnitude estimates derived from:
Price WaterhouseCooper, *Measuring the Automotive Retail Revolution*, 1999.
Mckinsey and Company, *Automotive Retailing*, 1998.

another 1 percent of the MSRP on making attractive leases available to the public. This is also oriented toward interbrand competition.

Even dealer discounts (running at about 3 percent of MSRP) are unlikely to be reflective of intrabrand competition. These discounts are generally available to all dealers. If any dealer needs the discount to make the sale, he can give it, but so too can the next dealer. The dealer discount reflects not so much competition between dealers as relative bargaining between dealers and consumers.

Second, there would appear to be more spent on brand specific advertising (particularly on television) than on dealer specific advertising. Manufacturers spend a great deal on advertising their brands (about 3 percent of the MSRP). Again, if interbrand competition were not driving manufacturers then they would stop this advertising and pocket the money.

Dealers spend about as much on advertising as manufacturers. While this would largely be oriented toward intrabrand competition, some of it is regional interbrand competition (e.g. see your Washington area Toyota dealer advertising).

As described in Exhibit 7, these marketing and advertising expenses that seem to be driven by interbrand competition constitute about 14 percent of the manufacturer suggested retail price. These large expenditures, about $3,000 per automobile, are one of the most powerful indicators of the existence of interbrand competition. Moreover, it appears that about five times as much is devoted to interbrand competition as to intrabrand competition. Manufacturers are wasting a large sum, if interbrand competition is not the dominant factor in the market.

III. B. QUALITY AND COST

The second set of questions raised about lifting vertical restraints on automobile dealerships relates to the potential quality changes and cost saving. What is the likely impact on the total cost of delivering a car to the end user of eliminating these restraints on trade? If the reductions in cost are significant, consumers would likely be much better off. Indeed, if the reductions in costs are sufficiently large consumers could be net winners even if there is some increase in manufacturer market power, since the shift in the supply curve would offset the ability to exercise market power. To the extent that interbrand competition exerts pressures on prices, at least part of the cost savings will be passed through to consumers. Given the strong indication of the predominance of interbrand competition, most will be passed through to consumers.

III. B. 1. Current Restrictions May Diminish Quality

The theoretical literature suggests that manufacturers would not have an interest in undermining the provision of services – called the aftermarket – in the automobile market. Their interests are served by a strong infrastructure for aftermarket services. Exclusive territories, bans on manufacturer ownership, etc., are no longer the only way to accomplish this infrastructure, if, indeed, they ever were.

In fact, because of the current structure of territorial restrictions, a good case can be made that vertical restraints are diminishing the consumer quality experience. By restricting the opening of new dealerships in growth areas or the creation of satellite facilities, it can well be argued that the territorial restrictions cause an under supply of service facilities where they are needed most. Moreover, because dealers are loathe to encroach on the territory of nearby dealers, satellite and other facilities are avoided.

The growth of an independent service sector in the past decade is strong evidence that service has become a competitive, stand alone business. The dealers themselves acknowledge this, as their annual report puts it,

> In recent years stiffer competition from independent service stations and quick-lube centers have hurt dealership's efforts to lure more customers back for service work.[94]

Results of a recent survey by Yankelovich sheds light on this issue. Whereas the dealership of purchase was used by 63% of respondents for warranty work, they preferred some other place in 66% of the cases for non-warranty work. Only five percent of respondents say they use some other dealers for either warranty work or non-warranty work.

There are conflicting forces operating in the service area. Warranty work is supported by the manufacturer, but it is carried out by the dealer. As warrantys lengthen, this relationship extends. Warranty work does not have to be carried out the dealer where the car was purchased. There should be vigorous competition for those warranty service. If consumers perceived this competition, we would not expect to see such a high percentage of warranty work from the dealer of purchase and such a low percentage for non-warranty work.

Dealerships capture a relatively small percentage of the total service market, while they have apparently lost business to non-dealerships. As the dealer's own association put it,

> Improvements in vehicle quality and short-term leasing are responsible for the decline in service contract penetration rates for a high of 35 percent in 1986 to 20.1 percent in 1998.[95]

Lifting the restrictions would immediately increase supplies in those areas. Consequently, any negative impact that vertical integration might have with respect to quality likely would be more than offset by this positive impact.[96]

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[94] National Automobile Dealers Association, *NADA Data 2000*, p. .

[95] Ibid.

[96] The EU Report finds consumer representative support severing the link between sales and service, while consumers behave as if the linkage were not important (pp. 72, 75),

> The majority of consumer associations hold the view that such a link is not indispensable and that a split would be advantageous for consumers, while a minority considers that a split would bring no change…
>
> The behaviour of these consumers puts in question the existence of a "*natural link*" between sales and after-sales. Such a link would basically require that the consumers use the after-sales department of

The other aspect of quality that arises in the discussion of vertical restrains are changes in the buying experience. This plays a prominent role in the analysis of online buying.

> The Internet can be expected to have a strong effect on car retailing because many – if not most – customers actively dislike contact with car dealerships and particularly salespeople. This stands in contrast to some other industries such as brokerage, where customers might like, or at lease feel neutral about, their broker. Consequently, online auto referral services advertise both their convenience and their ability to get low prices for consumers.[97]

We have already noted one particularly important area where the experience will be changed, the gathering of price information.

> An often ignored aspect of pricing is the amount of price information available to consumers. If brands come in many different variants, consumers face the computational task of making proper cross-brand comparisons for all different variants. This computational task is deliberately made more complex by the firms through the common business practice of selective price advertising. In the case of automobiles, advertisements often offer detailed information on the characteristics of the base model and all available options, including various engine variants. Information about the price, however, is usually limited to the base model, with a typical advertising quote 'model is available from… These practices may be interpreted as a strategic tool to lure potential customers to visit a store. If successful, they may explain significantly larger percentage markups on premium products than on base products.[98]

III. B. 2. Potential Consumer Savings

The potential to use the Internet for marketing and distribution could dramatically improve the efficiency in the industry. This constitutes a potential shift in the supply curve. In a competitive market, the price would fall to a new, lower equilibrium level. The stakes are quite large. The dealer costs of distribution constitute almost 30 percent of the manufacturers suggested retail price. This is made up of discounts that dealers offer to consumers to induce sales, advertising, interest expenses on inventory, profits and the costs of operations (brick, mortar and operations). Manufacturers also incur distribution costs. These include discounts and advantageous lease terms offered to consumers to induce sales as well as advertising costs.

Having concluded that interbrand competition is the cause of the discounts, we expect that the discounts would continue as distribution in the industry is transformed. Other costs could be lowered through efficiency gains and, in a competitive market, they would be passed through to consumers in substantial measure.

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the dealer from which they have purchased the car. Consumer behaviour, however, shows that this is to a considerable extent, no the case.

[97] Morgan, et al., p. 6.

[98] Verboven, p. 400.

Not all of these costs can be driven out of the market, but many can be reduced. Hard costs, like advertising and carrying costs could be reduced. Even the large cost of brick and mortar operations, while not being eliminated because of continued point of sale and service needs, could be reduced. Targeted marketing and personalized sales can reduce local advertising, personnel, consumer transaction and inventory carrying costs substantially. Manufacturers could also hope to reduce advertising costs by more efficiently targeting those expenses.

Estimates for these savings have consistently been in the range of $2000 - $4000 per car. These include three elements, parts exchanges, build-to-order and direct selling.[99] The costs that would be directly affected by elimination of the vertical restraints are build-to-order and direct selling. These are about $2500.

The European Union recently suggests percentage reductions in distribution costs as follows:

> It estimates that savings as a percent of price total for a car could amount to 2% (reduced discounting), 2.5% (reduced physical and managerial stock holding costs), 2.5% spending cost reductions, and 4% order mix. A change to the approach of pricing could also produce further profit improvements.[100]

Thus, both of these estimates suggests consumer savings on the order of 10 percent.

The quantitative studies of the price effects of vertical restraints on entry described in Exhibit 2 were based on pure market power analysis. For the purpose of estimating long term potential gains, however, these estimates of price reductions of 6-8 percent are assumed to be subsumed in the larger estimates of efficiency gains, even though there are indications that there would be independent pricing benefits associated with the reduction in dealer market power.

On a percentage basis, this middleman cost savings are only average compared to claims frequently made for e-commerce applications. Estimates of potential savings range as high as 20 to 30 percent.[101] A growing list of econometric studies puts the achieved savings from the early development of Internet-based sales in the range of 10 to 15 percent.[102]

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[99] Taylor, Alex, III, "Detroit Goes Digital," *Fortune*, April 17, 2000; Weidenbaum,

[100] EC Report, p. 47, citing ICDP, "Management Briefing No. 1," J. Brown, "Flexibility Pricing to Match Demand with Supply,"

[101] Consumer Energy Council of America, *The Convergence Phenomenon: A Consumer Perspective,"* April 2000, pp. 98-10; Tedeschi, Bob, "Online Shopping Better than the Mall?" *New York Times*, September 21, 1999.

[102] Brynjolfsson, Erik and Michael D. Smith, "Frictionless Commerce? A Comparison of Internet and Conventional Retailers," *Management Science*, April 2000; Smith, Michael D., Joseph Bailey and Erik Brynjolfsson, "Understanding Digital Markets: Review and Assessment," in Erik Brynjolfsson and Brian Kahin,*Understanding the Digital Economy* (MIT Press, Chicago: 2000); Brown, Jeffrey R. and Autan Goolsbee, "Does the Internet Make Markets More Competitive? Evidence from the Life Insurance Industry," *NBER*, June 29, 2000

At this early stage of the growth of Internet usage for new automobiles and other products and given the severe restraints on trade that have been places on the sales of new autos, it is only possible to give an order of magnitude estimate of potential savings. Based on the econometric estimates of the excess costs imposed on the public by laws that restrict entry of new auto dealerships, analyses of the cost structure of the current auto distribution network, and the growing body of econometric evidence on the cost savings and price reductions associated with Internet sales, savings of 10 percent per car are readily achievable over time.

Because the automobile is such an important consumer commodity the total dollar amounts are large. For example, the total sales through new car dealers totaled almost approximately 14 million units in 1999 with a total value of over $350 billion. Thus, even at the lower range of these estimates, total long runs savings would amount to tens of billions of dollars per year. The gains would build slowly, as increasing use of direct sales eroded the pricing power of dealers and transformed the distribution system.

Indeed, the detailed studies of the impact of restrictive franchise laws done before the Internet dramatically increased the potential efficiency gains from a more streamlined distribution system found potential savings of at least 6 percent per vehicle. At today's prices and volumes the potential savings are on the order $1,500 per vehicle, or more than $20 billion per year.

IV. PUBLIC POLICY

While it is possible to conceive of situations in which the ongoing restrictions on entry of dealerships and sale of vehicles could be in the public interest, the empirical evidence overwhelming favors the conclusion that it is not. Elimination of these vertical restraints would result in consumer gains because

- prices would decline due to the increase in competition;
- inefficiencies which are shielded from competition would be squeezed out of the distribution chain;
- service quality would improve by eliminating barriers to deployment of dealer-based satellite facilities.

The public policy recommendation that emerges is straightforward – more competition would be better. Allowing automobile manufacturers and third parties to sell directly or provide information to the public adds a more efficient sales channel and should be encouraged if proper safeguards against the exercise of market power are in place. A balance should be struck between the need to impose licensing and other requirements on new entrants into the automobile sales business to ensure consumer protection, with the need to open this important market to more competition.

As competition is introduced into the distribution of automobiles, consumers would continue to have the full protection of general consumer protection statutes and the array of laws that apply specifically to automobiles. Restricting entry into the auto dealer business is a most inefficient and least consumer-friendly way to achieve this consumer protection. Allowing new entrants into the sale and distribution or automobiles does not mean that they would be deregulated. Reasonable licensure or bonding requirements that also allow efficiency and competition between a full array of sellers, and opens new, more efficient distribution channels, would be a far more consumer-friendly way to organize this important business.

A balance should be struck between opening distribution channels and the possibility of manufacturers discriminating against dealers or others in making automobiles available. Where auto manufacturers are allowed to sell directly to the public, requirements that manufacturers not discriminate against dealers, against whom they would be competing in the availability and price of vehicles, should be enacted. Dealers should have a private right of action to pursue claims of discrimination under contract law. By allowing private parties to have a private right of action to enforce nondiscriminatory treatment, market negotiations and market discipline would remain the primary disciplinary force and excessive regulation is avoided.

Litigation may result in the early stages, as the new business relationships are worked out, but ultimately, the new legal/economic structure will stabilize at a much lower cost to consumers. The frequently heard objection to this type of solution is that it introduces a complex regulatory or litigative process into the market. In the case of laws restricting sale of automobiles, this approach would actually simplify regulatory oversight. In regulating entry states have enacted a wide range of regulatory tests on the industry. At present, regulatory bodies are charged with determining when entry is in the public interest. Across the states, they are directed to consider many factors.

In other words, the states have been willing to intervene in the automobile market in the past twenty-five years to protect the interests of dealers as dramatic competitive changes have taken place. The changes that are being driven by the information revolution and the Internet are too powerful and important to be ignored. A vigorously procompetitive, proconsumer reform to open up automobile distribution to the huge efficiency gains available through direct marketing facilitated by the growth of the Internet economy would definitely be in the public interest. It is time for the states to intervene a little less and allow consumers to benefit from the rationalization of automobile distribution.