Corporate Welfare: How Automobile Dealership Franchise Regulations Cost Consumers an Additional $48 Billion Annually

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This ConsumerGram explores the consequences of various state laws written to advantage automobile dealer franchises. Because many of these laws work to increase vehicle costs and set geographic restrictions that limit price competition, they serve to transfer income from the buying public to dealerships. Specifically, this ConsumerGram finds that American consumers collectively pay $47.5 billion more per year on the purchase of new automobiles due to regulations that limit dealership competition. Because there is a host of other dealer-friendly laws being enacted and proposed, the total harm to consumers is likely to be much higher than measured here. This raises a question -- why do state legislatures act to advantage already profitable businesses at the expense of consumers?

Regulation and Protection

Not long after automobiles reached the mass market, manufacturers experimented with different distribution models, eventually settling on dealership franchises as the channel of choice. The resulting contractual arrangements between dealerships and manufacturers were, and still are, mutually beneficial in that both parties require each other to be successful and profitable in order to insure their own success.

Early on, the automobile manufacturing industry began to consolidate from more than one hundred carmakers, eventually reaching three major domestic producers by the 1920s. Over the ensuing decades, some franchise owners expressed concerns that carmakers had market power that could provide negotiating and operational leverage over small franchised

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dealerships.[2] Some dealerships also argued that major investments in showrooms and an inventory of cars could tie up capital and make dealerships vulnerable to short term market fluctuations and demands by major manufacturers.

In the decades to follow, states began enacting laws to protect local franchises from alleged abuses by automobile manufacturers. In 1956, a federal law was established to limit manufacturers from terminating dealerships and preventing dealers from being forced to purchase vehicles from manufacturers. When this federal law was enacted, 20 states had already similar laws in place. Since then, state regulatory protections for automobile dealer franchises became the norm. What started as a voluntary agreement between manufacturers and dealerships as their sales channels is now a regulatory requirement.[3]

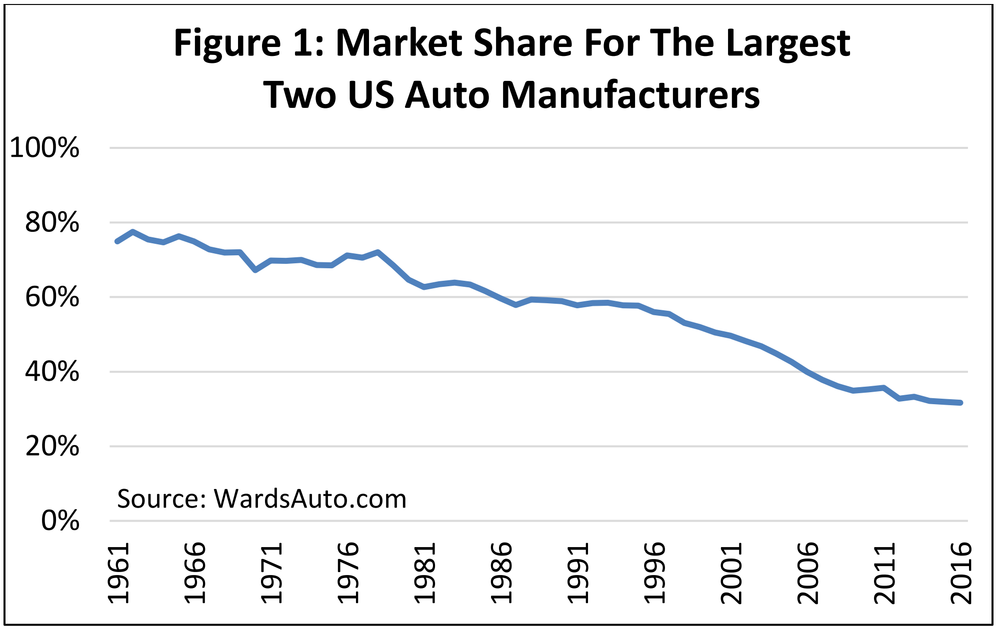
No Evidence of Market Failure to Justify State Regulations

The interdependence between manufacturers and dealerships require that both be successful. Without profitable dealerships, manufacturers cannot sell their products. That was true fifty years ago and that is still true today. This means that there really is no incentive for manufacturers to squeeze dealerships, since that would cause dealers to exit the market and reduce car sales at the financial loss of manufacturers. Moreover, what prospective dealerships would want to enter a market if the prospects for success were low? Given the mutually beneficial relationship between franchises and carmakers, the argument that manufacturers have incentives to exert an unfair advantage over dealerships would appear to be hyperbole by those seeking favorable legislation and not based on sound microeconomic thought.

While some older arguments point to the hypothetical risks from market concentration and high capital-intensity, these arguments lack any empirical support today. For one, the vehicle manufacturing market is no longer concentrated. As **Figure 1** (below) shows, the top two manufacturers have seen their combined market share fall from nearly 80 in the early

[2] Francine Lafontaine and Fiona Scott Morton, "State Franchise Laws, Dealer Terminations, and the Auto Crisis," *Journal of Economic Perspectives*, 24:3, 2010.
[3] "State Franchise Law Carjacks Auto Buyers," Mercatus Center, George Mason University, January 20, 2015.

sixties to 30% today, as nearly twenty foreign manufacturers now successfully compete in the U.S. market. In other words, it is a competitive industry. Moreover, the capital-intensity of industries is a cost of doing business and one that is hardly unique to car dealerships.[4] Most importantly, there is no evidence of market failure to justify government interference.



Welfare for the Rich?

While there is no market failure that would warrant a government remedy, some might portray car dealerships as financially struggling small businesses that urgently need the government's help to succeed. However, the empirical evidence shows that, collectively, dealerships are financially sound, averaging about 30% return on equity for domestics.[5] In fact, there have been a handful of billionaire car dealers, several owning NFL and other major sports teams.[6] Opportunities for high profits is one reason why billionaire Warren Buffett purchased a

[4] Comparing automobile manufacturing to the retail segment "motor vehicles and parts dealers," shows manufacturers spend twice the capital as a percent of value-added output than dealers, according to Gross Product Originating data, Bureau of Economic Analysis at https://www.bea.gov/industry/gdpbyind_data.htm.
[5] "Dealership Financial Profits," National Automobile Dealers Association, Domestic Dealership Profile, November 2017, https://www.nada.org/WorkArea/DownloadAsset.aspx?id=21474853576.
[6] "Forbes 400," *Forbes*, at https://www.forbes.com/forbes-400/list/#version:static_industry:Automotive, accessed online on February 4, 2018; and "Billionaires list confirms it: There's money in the car biz," *Automotive News*, March 11, 2013.

car dealership that operates in seven states, making the seller of that transaction yet another billionaire car dealer.[7]

Meanwhile, the automobile manufacturing industry has not managed to reach 8% or more in profits in any year during the last decade, a rate reportedly insufficient to recover its return on capital.[8] Because state laws make little distinction between large and small dealers or between wealthy or less wealthy dealers, the focus of these laws is not to help the "little guy." Instead, dealership-friendly legislation represents welfare for the rich at the expense of consumers because they ultimately push car prices higher.

Government Failure: The Spread of Regulations

Arguments that dealerships need help are weak at best, but the regulations justified by these arguments persist. In fact, despite the lack of empirical evidence support, state legislatures have continued to pass laws favoring dealerships. From 1979 to 2014, laws protecting dealerships from termination increased from 45 states to all 50 states; franchise licensing protection laws for dealers increased from 44 states to 50 states; laws preventing manufacturers from forcing dealers to accept deliveries of vehicles increased from 37 states to 48 states; and exclusive territory protection laws for dealers increased from 27 states to 49 states.[9] Today, all states have passed dealership-friendly franchise regulations, including laws that give automobile dealerships territorial exclusivity and encroachment protections from competition.

[7] Brendan Coffey, "This Car Dealer Turned Billionaire Got a Little Help from Buffet," *Bloomberg*, September 24, 2015; and Amarendra Bhushan Dhiraj, "5 Billionaire Car Dealers; Would You Buy a Car from Warren Buffett?" *CEOWORLD Magazine*, October 3, 2014.

[8] Rich Parkin, Reid Wilk, Evan Hirsh and Akshay Singh, "2017 Automotive Trends: The Future Will be Rocky for Auto Companies Unable to Improve Returns on Capital," PwC, Strategy& Group, 2018, downloadable at https://www.strategyand.pwc.com/media/file/2017-Automotive-Industry-Trends.pdf.

[9] "State Franchise Law Carjacks Auto Buyers," Mercatus Center, George Mason University, January 20, 2015; and Francine Lafontaine and Fiona Scott Morton, "State Franchise Laws, Dealer Terminations, and the Auto Crisis," *Journal of Economic Perspectives*, 24:3, 2010 (also see an updated appendix accessed on January 20, 2015, at https://assets.aeaweb.org/assets/production/articles-attachments/jep/app/2403_morton_app.pdf).

Territorial exclusivity laws protect dealerships by establishing monopoly market areas that work to reduce intra-brand rivalry. These laws limit market entry and effectively reduce price competition between dealers selling the same brands and models, thereby leading to higher consumer prices and increased dealership profits. By constraining entry and exit, the market is less able to adjust to swings in demand and less able to maximize economies of scale and scope. This adversely effects operational efficiency, and it raises per unit costs and consumer prices.

While the economic theory on entry barriers is clear, so is the empirical evidence. One 2015 econometric study found "relatively strong" intra-brand price effects associated with the geographic distribution of dealerships.[10] For example, the study estimated that the price of a Honda Accord would increase by $220 and by $500 when dealers were 10 and 30 miles apart, respectively. In other words, state laws that protect dealerships by allowing territory exclusivity work to increase consumer prices for new vehicles, as well as increase dealership profitability. Economic theory finds that monopoly performance leads to increased consumer prices and profits, as well as restricted industry output and decreased consumer welfare.[11]

Along with exclusive territories and market entry barriers, as noted earlier, state laws have been in place that constrain dealership termination. Generally, state laws do not consider gross inefficiency or financial conditions as potential grounds for termination. Even when good cause for determination can be found, many states provide dealerships time to remedy shortfalls, making termination difficult and costly for manufacturers. Usually, termination requires manufacturers to buy-back unsold cars, as well as parts, accessories, tools and equipment, which further raises the cost for manufacturers.[12] Because state laws impede

[10] T. Randolph Beard, George Ford, Lawrence Spiwak, "The Price Effects of Intra-Brand Competition in the Automobile Industry: An Econometric Analysis, Phoenix Center for Advanced Legal & Economic Public Policy Studies, Policy Paper No. 48, March 2015.

[11] Consumer welfare is an economic measure of consumer benefits. The welfare decrease noted here includes allocative inefficiencies referred to as the *deadweight loss* to society.

[12] Francine Lafontaine and Fiona Scott Morton, "State Franchise Laws, Dealer Terminations, and the Auto Crisis," *Journal of Economic Perspectives*, 24:3, 2010.

dealership entry and exit, market forces are not present to determine the optimal number of competitors in any given market and do not determine the most efficient size of dealership operations – yet another cost facing manufacturers, ultimately recovered in consumer prices.

Besides selling new vehicles and trading used vehicles, dealerships can profit many other ways. Manufacturers' warranties provide guaranteed business to dealerships, as well as providing additional traffic to showrooms. While manufacturers' warranties provide dealerships reimbursement for labor and parts, many state laws allow for high markups on reimbursement. In some cases, these markups can nearly double the price of parts, providing handsome profits to dealerships.[13] While these laws increase the reimbursement costs for manufacturers and ultimately automobile prices, these markups also create an incentive for much higher list prices for parts and services. That, in turn, means that consumers will face much higher prices when going to dealerships for services and repairs not covered under warranty.

The recall business is a "golden opportunity for car dealers to make money."[14] Besides profiting from recall reimbursement by manufacturers, dealers can also profit from additional customer services and additional showroom traffic. Yet, some states are considering laws to eliminate risks and downside to dealers. These laws propose additional payments (or interest fees) from manufacturers to franchises when cars sit on a dealer lots during recalls. These car dealer protections are costly for consumers and call into question why consumers should not be allowed to bypass dealerships altogether when buying new vehicles.

In this regard, most state laws prohibit consumers from buying directly from manufacturers, instead requiring dealerships to be the exclusive sales channel for manufacturers. Regarding prohibitions of direct-to-consumer sales, the FTC staff has written that these state laws are both anticompetitive and bad for consumers:

[13] Some urge dealerships to increase their markups and lobby state laws for higher reimbursements. See Leonard A. Bellavia, "Get What's Yours: Don't Be Afraid to Seek Higher Factory Repayment for Warranty Parts," *Fixed Ops Journal*, June 2017, p. 43.
[14] Lindsay Chappell, "There is Big Money in the Recall Crisis," *Automotive News*, April 11, 2016.

"A fundamental principle of competition is that consumers – not regulation – should determine what they buy and how they buy it. Consumers may benefit from the ability to buy cars directly from manufacturers – whether they are shopping for luxury cars or economy cars. The same competition principles should apply in either case."[15]

There are other laws that help dealerships at the expense of manufacturers and therefore consumers. Most states forbid manufacturers from forcing new vehicles on dealerships, prohibiting different treatment between dealerships operating within the same state that would otherwise drive out inefficiency, preventing different treatment between dealerships operating in different states, and requiring manufacturer incentives for dealership facility improvements whether improvements are ever made. Again, these provisions are costly for manufacturers, who can only recovery these costs by raising vehicle prices.

Despite the lack of empirical evidence showing market failure, state laws continue to be enacted that favor often well-heeled car dealers at the expense of car buyers. Contrary to the public interest, these state laws work to transfer income from consumers to car dealers.

Evidence of the Impact on Consumer Prices

A study by staff at the Federal Trade Commission (FTC) looked at restrictions on territorial and market entry, and empirically found that these regulations served to reduce competition – pushing up consumer prices in 1978 by 7.63% in markets with increasing populations and 6.14% overall.[16] By the study's admission, these estimates significantly understate the negative impact that regulations have on consumers costs. In addition, this study does not consider the costs of other state laws favoring dealers over consumers and manufacturers, which has grown significantly in the last decades. Also, since 1978, the U.S.

[15] Marina Lao, Debbie Feinstein and Francine Lafontaine, "Direct-to-Consumer Auto Sales: It's Not Just about Tesla," Federal Trade Commission, May 11, 2015.

[16] Robert P. Rogers, "The Effect of State Entry Regulation on Retail Automobile Markets," Federal Trade Commission, Bureau of Economics Staff Report, January 1986.

population has grown substantially, making competitive restrictions on relevant market areas substantially costlier than observed in the study.

Besides ignoring the many different franchise regulations that have been enacted, the political process produces other costs, commonly referred to as *rent-seeking*. Rent-seeking occurs when some economic entities (such as dealerships and manufacturers) expend political and lobbying resources to obtain or prevent economic gains that create no additional wealth or economic benefit for society.[17] While the study acknowledges that they did not include the historical costs associated with "rent-seeking" by dealers and others who spent funds to influence state and local politicians, the decades of accumulating and sweeping legislative activity has undoubtedly led to a massive misallocation of resources away from producing what consumers want.

Since none of these costs were included in the FTC study, its decades old data significantly understates the total costs of franchise regulations on society today. For simplicity, however, we conservatively assume that dealership-friendly regulations impose a modest 7.63% effect on consumer prices, as quantitatively measured in the FTC study.

Evidence on Market Performance

Short-run elasticity of demand for new automobiles has been estimated to be in the range of -1.2 to -1.5.[18] Taking the midpoint of this range, we assume the price elasticity to be approximately -1.35. As noted earlier, because these regulations provide dealers the ability to price over cost, removing these regulations would lower new vehicle prices and stimulate consumer demand, thereby increasing consumer welfare.

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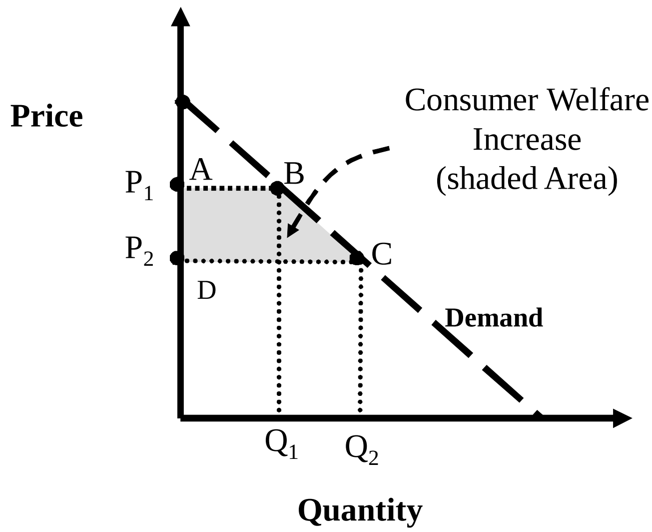
[17] This is a well-accepted notion in the economics of public choice literature. James Buchanan, Robert Tollison and Gordon Tullock, *Toward a Theory of the Rent-Seeking Society*, College Station: Texas A&M Press, pp. 97–112. 1980.
[18] Patrick L. Anderson, Richard D. McLellan, Joseph P. Overton and Gary L. Wolfram, Nov. 13, 1997, online at http://scholar.harvard.edu/files/alada/files/price_elasticity_of_demand_handout.pdf. Also see James W. Brock, *The Structure of American Industry*, Waveland Press, Oak Grove, IL., thirteen Edition, 2016, Chapter 6.

The benefits of increased consumer welfare resulting from a reduction in territorial regulations can be estimated and is depicted as the shaded trapezoid ABCD in **Figure 2** (below), labeled as the *Consumer Welfare Increase*. This welfare increase can be approximated by the reduction in price resulting from the decrease in state regulations (noted as the decrease from P_1 to P_2) and the corresponding increase in demand (noted as the increase from Q_1 to Q_2).

Figure 2: As Price Decreases, Consumer Benefits Increase



Motor Intelligence estimates that manufacturers delivered 17.2 million light vehicles during 2017.[19] Because regulations enable dealerships to price over cost, removing these regulations would lower prices by 7.6% and bring 2 million more vehicles to the U.S. market, based on the price elasticity of demand. Based on the average transaction price for vehicles for December 2017, the 7.6% decrease in price and corresponding 10.3% stimulation in market demand would produce consumer welfare improvement of roughly $47.5 billion per year – all

[19] Motor Intelligence, "U.S. Market Sales: U.S. Market Light Vehicle Deliveries – December 2017, Final Results," January 3, 2018.

from the elimination of territorial exclusivity regulations.[20] The sheer size of potential welfare gains demonstrates the significant costs these regulations impose on consumers.

The Public's Interest

Public policies that impose regulations and taxes on large businesses do not spare consumers the cost. This *ConsumerGram* discusses the many different types of state laws that are designed to help dealerships at the expense of automobile manufacturers and ultimately consumers. While the result of these regulations clearly increases costs for manufacturers, evidence is clear that it also does so for consumers. We find that state laws that establish and protect exclusive territories for dealerships are costing consumers $47.5 billion more per year. Considering the many other dealer-friendly regulations and the continued expansion in protectionist legislation, the estimate presented here should be considered low.

Successful automobile dealerships provide quality services to consumers that fully meet their needs. Success is not dependent on state legislatures for help. It is not the role of regulators to prop up poor performing businesses, particularly since the resulting laws serve only to undermine competition and to lead to reduced consumer benefits. The public policy focus here should be on the public's interest, not the manufacturers and not the dealerships interests.

In conclusion, policymakers need to stem these regulations and stop interfering with mutually agreed upon franchise contracts. These protectionist regulations are anticompetitive and clearly anti-consumer.

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About the American Consumer Institute Center for Citizen Research
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[20] "Average New-Car Prices Rise Nearly 4% for January 2018 on Shifting Sales Mix, According to Kelley Blue Book," February 1, 2018, at https://mediaroom.kbb.com/2018-02-01-Average-New-Car-Prices-Rise-Nearly-4-Percent-For-January-2018-On-Shifting-Sales-Mix-According-To-Kelley-Blue-Book.