

TESLA AND THE CAR DEALERS' LOBBY

Will an innovative, new carmaker bring about a long-overdue change to the automobile industry?

BY DANIEL A. CRANE

Tesla Motors, the offspring of entrepreneur Elon Musk (who brought us Pay-Pal and SpaceX), is the most exciting automotive development in many decades and a marquee story of American technological dynamism and innovation. The company's luxury electric cars have caused a sensation in the auto industry, including a review by *Consumer Reports* calling Tesla's Model S the best car it ever tested.

Despite the acclaim, Tesla faces enormous challenges in penetrating an automotive market that has been dominated for a century by internal combustion engines. Not only must it build cars that customers want to drive (and ultimately produce them cost-effectively), but it must build the battery-swapping and charging infrastructure that makes charging as easy and reliable as pumping gas. Those are tall orders.

But Tesla's research and development, technological, and infrastructure challenges seem to be dwarfed these days by political challenges mounted by the powerful car dealers' lobby. Tesla has chosen a direct-to-consumer distribution model, one that bypasses traditional franchised dealer networks. The carmaker is operating its own showrooms and interacting with consumers directly over the Internet. Not surprisingly, that model has struck a deeply negative chord with car dealers who prefer not to be cut out of the action. The dealers have responded by invoking decades-old laws aimed at curbing direct distribution by car manufacturers, and seeking new legislative or regulatory decisions aimed at closing any loopholes that might allow Tesla to distribute directly. Thus far, the dealers have succeeded in blocking Tesla in states like Texas, South Carolina, and New Jersey, and are continuing to mount their campaign on a state-by-state level as the company tries to grow its footprint.

The dealers have been successful largely because of their political clout in local elections, where they make significant campaign contributions. They have attempted to justify the direct distribution bans as a form of consumer protection and public safety regulation. Slowly, consumers are waking up to the fact that the dealers' arguments are completely unfounded. Consumer protection and public safety have nothing to do with those restrictions; they are protectionism for car dealers, pure and simple.

ORIGINS OF AUTOMOTIVE DISTRIBUTION RESTRICTIONS

State laws restricting direct distribution of automobiles are not a new phenomenon. They grew out of intensive lobbying efforts by car dealers in the 1930s–1950s, in response to perceived abuses of the franchise relationship by car manufacturers. At that time, the car companies were large, powerful, and few in number. Manufacturers would secure contracts that imposed draconian terms on the dealers. According to a 1956 U.S. Senate committee report, franchise agreements of the 1950s typically did not require the manufacturer to supply the dealer with any inventory and allowed the manufacturer to terminate the dealer at will without any showing of cause. Conversely, the manufacturers could often force dealerships to accept cars whether the dealers could sell them or not. Thus, the franchise agreements were perceived as shifting risk downward to dealers and reward upward to the manufacturer. Ford and General Motors, in particular, were accused of using their superior economic leverage to play extreme hardball with the dealers.

The dealers made some headway in the courts challenging the franchise agreements as contracts of adhesion—that is, contracts in which one side has all the bargaining power and uses that power to its advantage. But the relief the dealers ultimately

needed was legislative. During the 1930s–1950s, the dealers pressured Congress to enact a statutory scheme protecting the dealers, but they got relatively little of what they wanted. A 1940 study by the Federal Trade Commission, which had been encouraged by the car dealers, did find some franchising abuses by manufacturers, but the report’s headline was that the use of manufacturer power to squeeze the dealers actually created intense retail competition, to the benefit of consumers. The FTC also turned the tables on the dealers and accused them of various

anticompetitive or anticonsumer practices, such as “padding” new car prices, price fixing, and “packing” finance charges (i.e., charging fees without the buyer’s knowledge)—not the news the dealers wanted.

Eventually, the dealers secured a modest federal victory with the Automobile Dealers’ Day in Court Act of 1956, which allows dealers to bring a federal suit against a manufacturer who, without good faith, fails to comply with the terms of a franchise agreement or terminates, cancels, or refuses to renew a franchise.



PHOTO COLLAGE BY DAVID HERBICK

COMMERCE & TRADE

The dealers secured more significant victory in state legislatures. During the 1940s–1950s, states began to pass statutes governing automotive franchise relations. Today, such laws are on the books in all 50 states. Their terms vary, but they commonly include prohibitions on forcing dealers to accept unwanted cars, protections against termination of franchise agreements, and restrictions on granting additional franchises in a franchised dealer’s relevant market area.

The statutory provisions that trouble Tesla prohibit a manufacturer from distributing its cars directly to consumers, effectively requiring the manufacturer to deal exclusively through dealers. The legislative concern reflected in those statutes is that if a manufacturer integrated forward into distribution, it might compete unfairly with its own franchised dealers by undercutting them on price. As discussed below, if that concern was ever legitimate, it seems much less so in the current world of vigorous competition among a large number of manufacturers. But the key point is that the concern should not apply to Tesla or any other car manufacturer that wants to avoid franchising altogether. At most, if one were worried about “undercutting” by the

ple of significant consumer savings from direct distribution in Brazil, where such distribution is legal:

Since 2000, customers in Brazil can order the Celta over the internet from a site that links them with GM’s assembly plant and 470 dealers nationwide. By 2006, 700,000 Celtas had been produced and the car continues to be one of Brazil’s best sellers. Consumers have 20 “build-combinations” from which to configure a model of their choice, including colors and accessories, and can view each change as it is being made. GM built five distribution centers throughout Brazil to reduce transportation time from its assembly plant and buyers can track location of their car online on its way to delivery at a dealer of their choice. The time from configuration at the factory to delivery is only about a week, in contrast to the several week wait that can be common in ordering a car in the United States.

Predictably, U.S. dealers were no more sympathetic to Internet distribution than they were to manufacturers setting up their own showrooms. They put pressure on state motor vehicle commissions to shut down Internet sales. In 1999, the Texas Motor Vehicle Division shut down efforts by Ford to sell preowned vehicles over the Internet. The Texas statute made it illegal for anyone to serve as an automobile dealer in the state without a license and then made it illegal for manufacturers to obtain a license. In 2001, the U.S. Court of Appeals for the Fifth Circuit upheld that restriction against constitutional challenge.

The manufacturers’ frustrated efforts to deal directly kept a relatively low profile until Tesla burst onto the scene several years ago. The combination of Tesla’s revolutionary new technology, the flamboyance of Musk, and his decision to bypass dealers altogether thrust the issue into the national spotlight.

If legislators were truly worried about carmakers undercutting franchisees, then the law would prohibit carmakers from having both direct retailing and franchising, instead of just prohibiting direct retail sales.

manufacturer, the rule should be a prohibition on manufacturer retail operations for manufacturers that also franchise, not for those that bypass franchising altogether. Nonetheless, the dealers have thus far enjoyed success in utilizing the prohibitions to block direct distribution that bypasses dealers.

ALONG COMES THE INTERNET

With the advent of the Internet, manufacturers began to see the opportunities to deal more efficiently with consumers by allowing buyers to place direct Internet orders for new cars. A 2009 research paper by a Justice Department economist, citing a 2000 Goldman Sachs report, estimated that the cost savings to consumers from direct distribution could be as great as \$2,225 per vehicle, or 8.6 percent of the vehicle cost. The report explained that “[t]he components of those savings were as follows: \$832 from improvement in matching supply with consumer demand; \$575 from lower inventory; \$387 from fewer dealerships; \$381 from lower sales commissions and \$50 from lower overall shipping costs.” The Justice Report also pointed to a real-world exam-

FOUNDATIONAL ECONOMICS OF DISTRIBUTION

Before getting into the dealers’ arguments in favor of direct distribution bans, let us recall a few preliminaries on the economics of distribution. Distribution is merely one of the functions that a firm can decide to perform internally or else purchase on the market. As Ronald Coase observed in his 1937 article “The Nature of The Firm,” whether a company performs such services internally or buys them on the market is a question of the agency and transactions costs of those respective forms of distribution.

There are many reasons why manufacturers might prefer to distribute through independent dealers. It shifts the investment in distribution to someone other than the manufacturer, allowing the manufacturer to focus on its core competence in research and development and manufacturing. It shifts distribution deci-

sions to managers with local market knowledge. It may create economies of scale or scope as dealers sell several different brands under a single roof.

But there are also good reasons why a manufacturer might prefer to sell directly to consumers. The manufacturer may be concerned that the dealers will focus more on short-term sales maximization than long-term investment in building the brand. That could be particularly worrisome for a company like Tesla that is introducing a disruptive new technology that still needs to be proven in the market. Sales of the new brand may cannibalize dealer revenues earned from selling other brands, lowering their incentive to invest in promoting the new brand. Manufacturers may also fret that local dealers will be unsophisticated about new technologies and that training and monitoring will be easier if retail distribution stays in house.

There is no a priori reason to favor one model or the other. Some companies choose to distribute their goods only through independent dealers. Others, like Apple, follow a dual distribution path, distributing their products through both their own outlets and independent retailers. Finally, some firms prefer to do all of their own distribution. Competition in the market should inform firms whether they have chosen the optimal strategy or should rethink their distribution decision. But there is no reason for legislators or regulators to favor one method or the other.

DEALER ARGUMENTS IN FAVOR OF RESTRICTED DISTRIBUTION

Since Tesla has shone an unflattering spotlight onto the dealers' favored regulations, the dealers have been busy explaining themselves. Alas, their arguments are so problematic that they only serve to bolster the view that the restrictions are pure protectionism.

The dealers' leading argument is that banning direct distribution is a form of "consumer protection." They argue that creating "competition" in retail distribution of cars is necessary to prevent manufacturers from price-gouging customers. But the idea that a vertically integrated manufacturer has a "monopoly" over the brand's retail distribution that needs to be broken up by outsourcing the retail function to independent dealers is farcical. As economists have long understood, if a manufacturer has market power, it will extract the full monopoly profit regardless of whether it sells to dealers or end users. It will be fully embedded in either the wholesale or retail price. Since retail distribution is just a cost of doing business, Tesla will increase its monopoly profits by minimizing the cost of retail distribution because then it will sell more cars. If anything, outsourcing the retail distribution function to locally dominant automobile dealers could lead to double marginalization and increased prices. Hence, as the Supreme Court has repeatedly noted in the vertical restraints context, the interests of consumers and manufacturers are aligned in

disfavoring dealer market power. Neither Tesla nor any other manufacturer can increase its profits by adding a monopoly markup to the retail price. Thus, if retail price competition is the concern, we should be far more concerned about the incentives of dealers than manufacturers.

The dealers also argue that having local dealers is necessary to ensure that customers are adequately served. For example, Bob Glaser of the North Carolina Automobile Dealers' Association has asserted that the restrictions are a form of "consumer protection" because "a dealer who has invested a significant amount of capital in a community is more committed to taking care of that area's customers." The obvious rejoinder is that Tesla and other manufacturers have as much interest as the dealers—if not more—in seeing that customers get the level of service that they are willing to pay for. If Tesla gets a bad reputation for quality, it will fail and never recoup the billions of dollars it is investing in creating new technologies. Car manufacturers make considerably larger brand-specific fixed capital investments than do dealers, and hence have greater incentives to protect the long-term integrity of the brand.

The dealers also argue that the restrictions are necessary for public safety. The dealers have pounced on recent news that GM failed to recall certain vehicles with safety problems, leading to tragic losses of life. But it is hard to understand how that episode supports the arguments against direct distribution; those failures to issue safety recalls occurred while GM was distributing through traditional dealer networks. The dealers argue that product recalls are a cost to manufacturers, whereas they are an opportunity to dealers to earn income. But that argument is false. Dealers do not make the decision to issue safety recalls. Those decisions come from the manufacturer and the National Highway Traffic Safety Administration. Once a safety recall has been issued, either a dealer or the manufacturer can service it.

Tellingly, I am unaware of any consumer group supporting the dealers' consumer protection arguments. That leaves one last major category of argument for the dealers: independent dealers are civic bastions of local communities and therefore deserve to be specially protected. Whether that is true—and whether the dealers make better philanthropic citizens than would any other economic special interest granted a protected position—is entirely speculative. But if the model of direct distribution is so superior to franchised distribution that eliminating legal protections would put the dealers out of business, then there must be something systematically inefficient about franchised distribution. In that case, both consumers and local communities would be better served if state legislatures just levied a tax on auto sales and distributed the money pro rata to local civic organizations.

SELECTIVE EXEMPTIONS AND CRONY CAPITALISM

Since direct distribution bans seem impossible to justify on any

COMMERCE & TRADE

rational economic grounds, both the dealers and some other manufacturers have turned the argument into one against favoritism for Tesla. For example, as Ohio was recently considering legislation that would create a special direct-dealing exemption for Tesla, GM wrote a public letter to Ohio Gov. John Kasich (R) complaining about the proposed legislation. What was most telling about GM's letter was its straightforward admission that allowing Tesla to engage in direct distribution would give the carmaker a "distinct competitive advantage" and would create a "significant disparate impact" on competition in the auto industry. That is tantamount to a confession that direct distribution is more efficient. If Tesla will gain a competitive advantage by bypassing dealers, shouldn't we want *all* car companies to have that same advantage?

GM is quite right in complaining that permission to engage in direct distribution should not become a special privilege that is handed out through backroom deals. That would just further the anticompetitive and anticonsumer distortions created by the sort of crony capitalism the dealers have already succeeded in implementing. Rather, direct distribution should be an option available to all manufacturers.

That brings the argument back full circle to the original purpose of the state direct distribution prohibitions: preventing manufacturers from competing with their own franchised dealers. Apart from the frivolous consumer protection arguments, should there still be a concern that manufacturers will take unfair advantage of their dealers by undercutting them on price at retail? Even if that argument had some validity at a time when the Big Three Detroit manufacturers controlled the entire U.S. market, it has none today. There are now seven large manufacturers selling over 100,000 units a month in the U.S. market and many smaller manufacturers with significant sales. Dealers have a choice of manufacturers for whom to distribute and therefore significantly greater clout in franchise negotiations. Many dealerships are no longer small mom-and-pop organizations but large multi-location and even multi-state ventures. The dealers should protect their interests through contractual negotiations rather than through protectionist legislation.

THE POLITICS OF GETTING IT RIGHT

Public choice theory teaches that small groups of people with a large economic interest in protectionist legislation will often be successful at implementing such regulations if the costs are spread over a broad group of consumers, none of whom has a sufficient individual interest in seeking to overturn the legislation. Such theories explain the persistence of the direct distribution bans in the face of evidence that they are harmful

to consumer welfare and completely unrelated to their ostensible justifications.

There are signs, however, the dealers' grip may be slipping. Tesla sees direct distribution as critical to the success of its business model and appears to be settling in for a long ground war. In the meantime, voices from across the political spectrum have pointed out the absurdities of the direct distribution bans. In March, I spearheaded an open letter about New Jersey's ban to Gov. Chris Christie (R). The 72 distinguished economists and law

General Motors admitted that allowing Tesla to engage in direct distribution would give the carmaker a "distinct competitive advantage" and would create a "significant disparate impact" on competition in the auto industry.

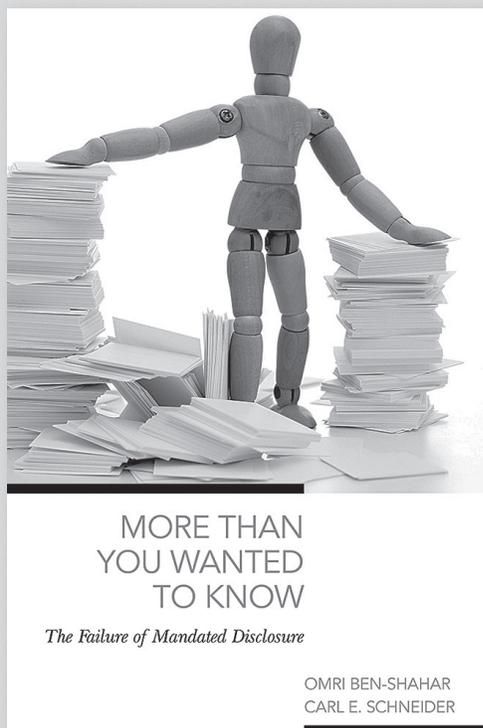
professors who signed the letter come from across the political spectrum and make an unusual coalition, but they are unified in explaining these laws as anticonsumer protectionism. Since the Tesla story gained momentum in national news media, several of the leading contenders for the 2016 Republican presidential nomination as well as prominent politicians from both parties have publicly announced support for allowing direct distribution. The dealers surely will not give up easily, but the opposition is strengthening.

Direct distribution of cars has emerged as a national political issue because of the environmental and technological salience of electric cars and tremendous appeal of the Tesla brand. Similar stories occasionally emerge when a sympathetic or quirky set of facts makes a compelling story, as when a group of Louisiana monks successfully sued for the right to make and distribute caskets against the self-interested wishes of the Louisiana State Board of Embalmers and Funeral Directors. Regrettably, many industries remain bound by protectionist rules designed to insulate the industry incumbents from competition. Car manufacturers should have the right to choose the most efficient means of distribution, and so should everyone else. R

READINGS

- "Are Plaid Jackets Finally Going Out of Style?" by Tim Rowland. *Regulation*, Vol. 36, No. 3 (Fall 2013).
- "Economic Effects of State Bans on Direct Manufacturer Sales to Car Buyers," by Gerald R. Bodisch. Economic Analysis Group, Antitrust Division, U.S. Department of Justice, May 2009.
- "On the Nature of the Firm," by Ronald Coase. *Economica*, Vol. 4 (1937).
- "State Automobile Dealer Franchise Laws: Have They Become the Proverbial Snake in the Grass?" by Jessica Higashiyama. Unpublished paper, University of California, Hastings College of the Law, April 2009.

New from Princeton



More Than You Wanted to Know

The Failure of Mandated Disclosure

Omri Ben-Shahar & Carl E. Schneider

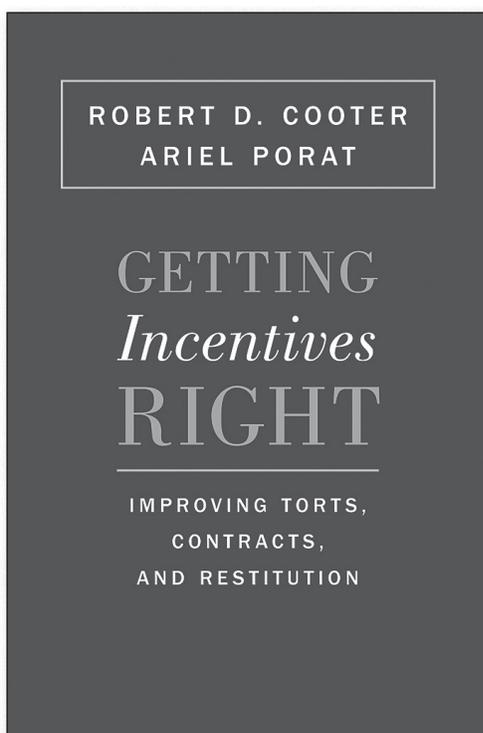
“Magnificent. Ben-Shahar and Schneider have done a masterful job of setting out their case clearly, plainly, and persuasively.”

—Tom Baker, University of Pennsylvania

“Significant and original. The research is prodigious. I am not aware of another treatment of disclosure that crosses disciplinary lines to this extent, and the analysis is all the more worthwhile for it. Ben-Shahar and Schneider show how disclosures have become pervasive in our society yet are largely ignored and misunderstood.”

—Clayton Gillette, New York University

Cloth \$29.95 978-0-691-16170-9



Getting Incentives Right

Improving Torts, Contracts, and Restitution

Robert D. Cooter & Ariel Porat

“Cooter and Porat are the most innovative and inspirational law and economics scholars of our generation. This is a work that every scholar in the field and every respectable academic library will want to own.”

—Francesco Parisi, University of Minnesota Law School and University of Bologna

“This timely book presents Cooter and Porat’s full perspective on the challenges that three important bodies of law—torts, contracts, and restitution—face in inducing optimal behavior. The result is a unique book that I have no doubt will become one of the leading texts in its field. Thought-provoking, original, and useful, it fills a void in the current legal literature.”

—Ehud Guttel, Hebrew University Law School

Cloth \$39.50 978-0-691-15159-5