Written comments of Jerry Ellig
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January 12, 2016

Auto Distribution: Current Issues and Future Trends
Federal Trade Commission Workshop

Dear Commissioners:

The Federal Trade Commission's (FTC's) workshop examining the effects of state regulations on competition in motor vehicle distribution is timely and relevant. As deputy director of the FTC's Office of Policy Planning, I helped plan the FTC's 2002 workshop on anticompetitive barriers to electronic commerce, which included a panel on automobile distribution that examined some of the same state regulations the FTC is considering in the current workshop.[1] A great deal of the FTC staff's research was subsequently published in the *Journal of Law, Economics & Policy*.[2] More recently, a colleague at the Mercatus Center at George Mason University and I published a short research summary, attached to this letter, that revisited the state regulatory issues.[3] In brief, we found that state regulation of automobile distribution continues to protect established dealers at the expense of consumers by preventing manufacturers from experimenting with new distribution models.

Virtually all states require auto manufacturers to sell new vehicles through local franchised dealers, protect dealers from competition in Relevant Market Areas, and terminate franchises with existing dealers only after proving they have a "good cause" to do so. In 1979, fewer than half of all states regulated all three of these aspects of the manufacturer-dealer relationship. By 2014, all but one state regulated every single one of these aspects. These state laws harm consumers by insulating dealers from competition and forestalling experimentation with new business models for auto retailing in the twenty-first century.

The state-mandated restrictions in new car markets are part of a larger class of business arrangements between producers and retailers known as "vertical restraints." Economic research finds that voluntarily adopted vertical restraints often benefit consumers, but state-mandated vertical restraints virtually always harm consumers.

[1] See FTC, "Public Workshop: Possible Anticompetitive Efforts to Restrict Competition on the Internet," transcripts, October 8–10, 2002.
[2] Deborah J. Holt, "Automobile Distribution Restrictions: An Economic Perspective," *Journal of Law, Economics & Policy* 3, no. 2 (2007): 137–54; John T. Delacourt, "New Cars and Old Laws: An Examination of Anticompetitive Regulatory Barriers to Internet Auto Sales," *Journal of Law, Economics & Policy* 3, no. 2 (2007): 155-88.
[3] Jerry Ellig and Jesse Martinez, "State Franchise Law Carjacks Car Buyers," *Mercatus on Policy* (January 2015).

New competitors, such as Tesla Motors, seek to sell motor vehicles directly to the public instead of establishing franchised dealer networks. The FTC's workshop announcement also raises the possibility that new developments, such as vehicle sharing and connected vehicles, could alter incentives for vehicle ownership in ways that might spur changes in existing distribution arrangements. Disruptive, dynamic competition can sometimes allow firms to overcome entry barriers that would otherwise protect incumbent firms, since dynamic competitors by their very nature possess cost or quality advantages. However, the one type of entry barrier that dynamic competition cannot easily overcome is a government-imposed mandate. When regulation prohibits entry or raises rivals' costs, superior efficiency alone does not allow a new competitor to enter a market. This point is explained in greater detail in my recent submission to the EU Internal Market Subcommittee of the House of Lords' Select Committee on the European Union, which is also attached.[4]

A pro-consumer policy would make franchising, exclusive territories, and termination protections voluntary rather than mandatory. Under voluntary contracting, these business practices could still survive when their benefits to consumers exceed the costs.

I do not claim to know the optimal way of organizing auto distribution and retailing for the industry as a whole or any individual automaker. The auto dealers' trade association argues strenuously that the current system of franchised dealers will always out-compete a system of manufacturer-owned dealerships. If this is true, the current franchise system should not need the legal protection it enjoys in every state.

Please let me know if I can furnish additional information or otherwise be of help to the commission or its staff.

Sincerely,

Jerry Ellig
Senior Research Fellow

Attachments:
Jerry Ellig and Jesse Martinez, "State Franchise Law Carjacks Car Buyers."
Jerry Ellig, "Dynamic Competition, Online Platforms, and Regulatory Policy."

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[4] Jerry Ellig, "Dynamic Competition, Online Platforms, and Regulatory Policy," statement submitted to the House of Lords Select Committee on the European Union, EU Internal Market Sub-Committee, December 9, 2015.

MERCATUS ON POLICY

State Franchise Law Carjacks Auto Buyers

Jerry Ellig and Jesse Martinez

January 2015

MERCATUS CENTER
George Mason University

Virtually all states require auto manufacturers to sell new vehicles through local franchised dealers, protect dealers from competition in Relevant Market Areas (RMAs), and terminate franchises with existing dealers only after proving they have a "good cause" to do so. These state laws harm consumers by insulating dealers from competition and forestalling experimentation with new business models for auto retailing in the twenty-first century. A pro-consumer policy would make franchising, exclusive territories, and termination protections voluntary rather than mandatory. Under voluntary contracting, these business practices could still survive when their benefits to consumers exceed the costs.

THE UBIQUITY OF DEALER PROTECTION LAWS

The first automobile franchise was established by William Metzger, who purchased the right to sell steam engine cars by General Motors in 1898.[1] What started as a voluntary agreement between a manufacturer and a retailer has turned into a mandatory requirement in all 50 states and in US territories.[2] State auto franchise laws extensively regulate the contractual obligations between manufacturers and dealers. They prevent manufacturers from selling new vehicles (and related services) directly to the public, often mandate exclusive territories for dealers, and make it difficult for manufacturers to terminate dealers.

State auto franchising regulations have become ubiquitous during the past three decades. As figure 1 shows, all three types of laws—franchise licensing requirements, exclusive territories, and dealer termination provisions—became more common between 1979 and 2014. During those 30 years, states enacted 31 new laws on those topics. In 1979, fewer than half of all states regulated

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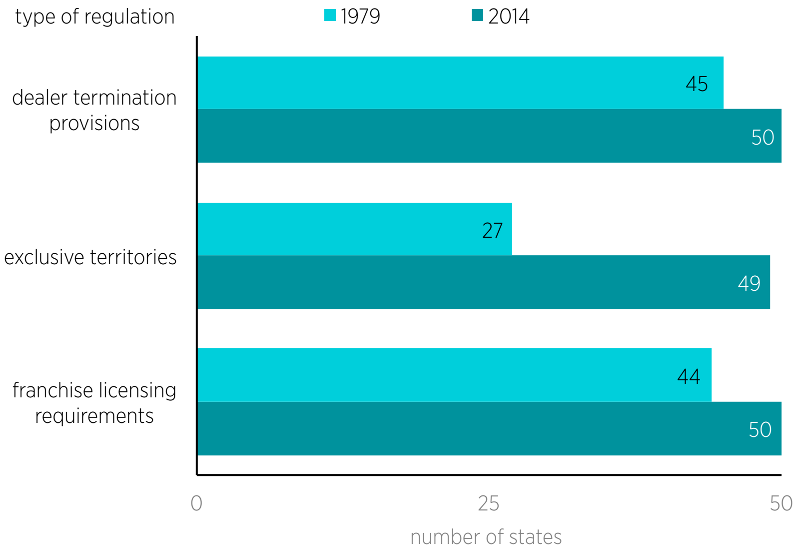
Jesse Martinez is a research assistant in the Regulatory Studies Program and Financial Markets Working Group at the Mercatus Center at George Mason University. His research focuses on the effects of state and federal regulations.

Figure 1. Number of States with Auto Regulations, 1979 vs. 2014



Source: Table A from Francine Lafontaine and Fiona Scott Morton, "State Franchise Laws, Dealer Terminations, and the Auto Crisis," *Journal of Economic Perspectives* 24, no. 3 (2010), as updated at "Web Appendix for State Franchise Laws, Dealer Terminations, and the Auto Crisis," accessed January 16, 2015, https://www.aeaweb.org/jep/app/2403_morton_app.pdf; authors' review of Arizona and Indiana statutes.

Note: Graphs are recreations of 2009 data compiled by Lafontaine and Morton and include two states which have codified exclusive territory statutes since 2009: Indiana and Arizona. See Indiana Code 9-32-13-24(d)–(f) and Arizona § 28-4452.

all three aspects mentioned above. By 2014, all but one state regulated every single one of these aspects.

RECENT CONTROVERSIES OVER DEALER PROTECTION LAWS

Although states have ramped up dealer protection, two recent policy controversies have called these laws into question. Electric automaker Tesla has sought to sell automobiles directly to the public, and federal supervisors of the Chrysler and General Motors bailout pressured the automakers to terminate numerous dealerships.

Tesla: Uprooting the Traditional Franchise System

Tesla's direct sales model runs completely counter to the traditional franchise model: Tesla (in states where it has been granted statutory exceptions to operate)[3] manufactures, prices, and services its own cars. CEO Elon Musk is betting that Tesla employees can learn about the car's new technology and sell more effectively than traditional independent dealers paid on commission.[4]

Regardless of whether he's right, so far state laws prevent him from finding out. Tesla's reluctance to operate franchises has led to legislative battles with states across the nation, including Michigan, New Jersey, Arizona, and West Virginia.[5]

Dealer Terminations after the 2008 Financial Crisis

The recession following the 2008 financial crisis highlighted the troubled relationship between US auto manufacturers and franchise dealers. New vehicle sales plummeted from 16,460,315 in 2007 to just 13,493,192 in 2008.[6] Following the imminent financial insolvency of Chrysler and GM, President Bush authorized emergency funding under the Troubled Asset Relief Program to aid the auto industry. The Obama administration further stipulated that these funds would only be released if Chrysler and GM restructured their operations to achieve "long-term viability."[7]

The administration woefully underappreciated the complexity of the manufacturer-dealer relationship. Chrysler's final restructuring plans submitted to the president's Auto Task Force called for shedding 789 dealers, while General Motors planned to cut more than 1,100 dealerships.[8] Chrysler and GM claimed that these dealers were unproductive and unprofitable.[9]

Dealers wasted no time petitioning Congress to reverse the planned dealer terminations. The 2010 Consolidated Appropriations Act (H.R. 3288) included a provision, Section 747, which provided the opportunity for "covered dealerships" to reacquire franchises terminated on or before April 29, 2009 through an arbitration process.[10] The provision affected all 2,789 dealerships slated for termination; however, the total count of dealers who decided to file paperwork to enter the process was 1,575. Of the cases that went to hearings, arbitrators allowed the manufacturers to close 111 dealerships and ruled in favor of 55 dealers. The other cases were settled or withdrawn.[11]

DEALER PROTECTION: VOLUNTARY VS. MANDATORY

The state-mandated restrictions in new car markets are part of a larger class of business arrangements between producers and retailers known as "vertical restraints." Economic research finds that voluntarily adopted vertical restraints often benefit consumers, but state-mandated vertical restraints virtually always harm consumers.[12]

Benefits of Voluntary Vertical Restraints

Franchising, exclusive territories, and dealer protection from termination can benefit consumers when they are adopted voluntarily by manufacturers and dealers. Auto dealers provide valuable services to consumers that some manufacturers are unwilling or unable to provide. These services include holding inventory, offering test drives, accepting trade-ins, and auto servicing and maintenance.

By contracting with franchised dealers instead of opening dealerships with their own employees, automakers create a powerful profit incentive for dealerships to undertake these efforts. Exclusive territories can further encourage dealers to invest in sales and service efforts by making it harder for consumers to visit a high-service dealer to learn about the vehicle but then buy it from a low-service dealer who can offer a lower price because he has not made a similar investment in sales and service efforts. Restrictions on termination can also spur dealer investment in both physical location and customer service by removing the risk that the manufacturer will demand further concessions from the dealer after the dealer has made the investments. Dealer sales and service efforts do not just benefit manufacturers; they also benefit consumers.[13]

Costs of Mandatory Vertical Restraints

When franchising, exclusive territories, and restrictions on termination become mandatory, however, manufacturers can no longer adopt other business models if circumstances change. Consumers suffer higher prices and less convenience as a result. Since most states now have these laws, it is difficult to estimate their effects by comparing prices in states with and without the laws. A study using data from 1972, when fewer states imposed these restrictions, found that the combined effect of all state auto franchise restrictions was to raise new car prices by about 9 percent.[14]

Preventing Direct Sales: Mandatory Franchising

Since state laws require manufacturers to sell new vehicles through franchised dealers, manufacturers cannot sell directly to the public.[15] This requirement prevents new manufacturers, such as Tesla, from establishing factory-owned dealerships.

Tesla's direct sales model could improve the dealership experience for consumers interested in purchasing an electric vehicle. A McKinsey analysis of the auto industry estimates the percentage of consumers who purchased a new vehicle and left the dealer dissatisfied with their experience at a relatively low 25 percent.[16] Researchers at the UC Davis Institute of Transportation Studies, however, found that 83 percent of customers in California who purchased an electric vehicle were dissatisfied with their dealer experience.[17] While it may work fine for many customers buying traditional vehicles, the franchise system may not provide a satisfactory experience for a significant number of consumers hoping to purchase an electric vehicle.

Mandatory franchising also prevents established manufacturers from selling directly to the segment of consumers who might prefer to avoid the dealership and simply order a car from the manufacturer, the same way many consumers buy built-to-order computers from manufacturers. Gary Lapidus, formerly a US auto industry analyst for Goldman Sachs, estimated that a build-to-order system could save consumers $2,225 on the price of a new car, based on an average price of $26,000 per car.[18] A position paper prepared for the National Automobile Dealers Association (NADA) disputes this figure, labeling it "a math exercise that assumed that such expenses would vanish in a direct distribution model."[19] Since manufacturer direct sales are illegal in all 50 states, neither manufacturers nor consumers have the opportunity to find out.

Finally, in some states mandatory franchising bars manufacturers from direct sales of used vehicles, direct financing of car purchases, or even direct sales of simple accessories.[20] For example, a shopper who wants to buy a Ford-branded locking gas tank cap or trunk cargo organizer at the ford.com web site is furnished with a "suggested retail price" and must input a zip code to find a local dealership from which to purchase the item.[21]

Restricting New Dealerships: Relevant Market Areas

Relevant Market Areas (RMAs) grant a dealer or group of dealers exclusive territorial rights by preventing the manufacturer from establishing additional dealerships within a given geographical area. In some cases, manufacturers and dealers may both find RMAs in their interest because they encourage dealers to invest in promotion of the brand. RMAs are mandated by law in every state except for Maryland, where dealerships only have the opportunity to file lawsuits against manufacturers to determine whether a "performance standard or program" based on "demographic" or "geographic" characteristics is unfair or unreasonable.[22] These statutes provide dealerships with exclusive territories and require manufacturers to prove a "need" for establishing a new dealership within such an area.[23]

RMA statutes help insulate dealers from competition. Without the threat that the manufacturer might open other competing franchises, existing dealers have the opportunity to charge consumers higher prices.[24] Since almost all states now have RMA laws, it is difficult to estimate how RMAs affect prices today. In the mid-1980s, when RMAs were less prevalent, Federal Trade Commission economists estimated that they increased the price of new cars by approximately 6 percent.[25] The percentage is arguably lower now, because the Internet has increased competition between dealers. A 2001 study found that Internet referral services save consumers about 2 percent on new car purchases[26]—a figure consistent with the hypothesis that the Internet has reduced, but not eliminated, the price-increasing effects of RMA laws.

Inflating the Cost of Dealership Networks: Termination Laws

Another legal protection provided to dealerships is restrictions on dealer terminations. Currently, every state has laws preventing dealership terminations except for "good cause."[27] The definition of "good cause" varies by state, but it usually focuses on factors like a dealer's conviction for a felony, fraud, insolvency, or failure to comply with a material term of the franchise agreement. States do not typically regard a manufacturer's desire to improve the efficiency of its dealer network as "good cause" to terminate dealers. Moreover, once a manufacturer has explained its "good cause," many termination laws also give the dealership a period of time (often 180 days) to correct the error.[28]

The arbitration process does not appear to have neatly resolved the issue of dealership terminations following the auto bailouts. Chrysler continues to deal with lawsuits from dealerships that closed following bankruptcy.[29] It is also worth noting that the bulk of cases were settled, which often entailed either reinstatement or monetary compensation.[30]

In the latter part of the twentieth century, state laws inhibited the Big Three US automakers from restructuring their dealership networks as Americans moved from the cities to the suburbs, migrated from the Northeast to the South and Southwest, and started buying vehicles from foreign manufacturers. Foreign manufacturers were less hampered by dealer termination laws because they did not enter the US market and establish their dealer networks until the 1970s.[31] While we don't know what the optimal dealership network is, research suggests that auto manufacturers with fewer dealerships require significantly fewer days of inventory, which can reduce costs substantially.[32]

CHANGING TIMES: CAN THE INDUSTRY GET BACK "ON THE ROAD AGAIN?"

Dealer protection laws effectively freeze the retail network. Mandatory restrictions make it difficult for manufacturers to experiment with new methods of auto sales or to close unprofitable and inefficient dealerships, which ultimately prevents any potential cost savings to consumers. And auto dealers vigorously defend these privileges. In a report that noted dealers earned record profits during the past year, a consulting firm that assists in the purchase and sale of dealerships sounded the call to arms:

> Since we are supporters of the franchise system that is working so well for all of us, we encourage our dealer friends, particularly those who own luxury stores, to lobby heavily to enforce the state laws that protect local dealers from factory owned dealerships. Customers will want to own Teslas, so maybe the best course of action would be to try to compel Tesla to award franchises to entrepreneurs just as all the other [original equipment manufacturers] have done.[33]

In short, state auto franchise regulations institutionalize anticompetitive pathologies.[34] We do not claim to know the optimal way of organizing auto distribution and retailing for the industry as a whole or any individual automaker. NADA's previously mentioned position paper argues strenuously that the current system of franchised dealers will always out-compete a system of manufacturer-owned dealerships.[35] If this is true, the current franchise system should not need the legal protection it enjoys in every state.

NOTES

1. Francine Lafontaine and Fiona Scott Morton, "State Franchise Laws, Dealer Terminations, and the Auto Crisis," *Journal of Economic Perspectives* 24, no. 3 (2010): 238.

2. Bill Canis and Michaela D. Platzer, *U.S. Motor Vehicle Industry Restructuring and Dealership Terminations* (CRS Report No. R40712, Congressional Research Service, Washington, DC, 2009), 25, http://digitalcommons.ilr.cornell.edu/key_workplace/667.

3. In Georgia, O.C.G.A. § 10-1-664.1(7) allows Tesla to sell cars directly to consumers as long as the number of sales is fewer than 150 per year. In Nevada, Assembly Bill 2 provides Tesla an exemption from franchise laws as an electric vehicle retailer. In Massachusetts, the Superior Court ruled that Massachusetts State Automobile Dealers Association could not prevent Tesla from selling cars directly to consumers.

4. Elon Musk, "The Tesla Approach to Distributing and Servicing Cars," *Tesla Blog*, October 22, 2012, http://www.teslamotors.com/blog/tesla-approach-distributing-and-servicing-cars. Here, Musk distinguishes between the benefits of the franchise model, which he considers to be a superior method of achieving greater overall market penetration, from the benefits of direct sales, which he posits is a superior method with regards to Tesla's strategy of increasing the market share of the electric vehicle.

5. Max Katsarelas, "Where Can Tesla Sell Cars?," *Mojo Motors Blog*, last updated May 20, 2014, http://www.mojomotors.com/blog/where-can-tesla-sell-cars/.

6. "New vehicles" are defined as cars and light trucks.

7. United States Department of the Treasury, "Program Purpose & Overview," last updated January 10, 2014, http://www.treasury.gov/initiatives/financial-stability/TARP-Programs/automotive-programs/Pages/overview.aspx.

8. Canis and Platzer, *U.S. Motor Vehicle Industry Restructuring*, 28.

9. Special Inspector General for the Troubled Asset Relief Program, *Factors Affecting the Decisions of General Motors and Chrysler to Reduce Their Dealership Networks* (SIGTARP Report No. 10-008, Office of the Special Inspector General, Washington, DC, 2010), refer to summary on first unnumbered page, http://www.sigtarp.gov/Audit%20Reports/Factors%20Affecting%20the%20Decisions%20of%20General%20Motors%20and%20Chrysler%20to%20Reduce%20Their%20Dealership%20Networks%207_19_2010.pdf.

10. Consolidated Appropriations Act of 2010, Pub. L. No. 111-117, 123 Stat. 3034 (2009).

11. American Arbitration Association, *A Report to Congress on: Automobile Industry Special Binding Arbitration Program* (November 2010), 4, 6, https://www.adr.org/aaa/ShowPDF?doc=ADRSTG_004331. Out of the 1,575 cases that filed, 803 were settled and 493 were withdrawn. Some dealers were reinstated before arbitration proceedings even started; Nick Bunkley, "Chrysler Dealers Find Barriers to Re-entry," *New York Times*, August 6, 2010, http://www.nytimes.com/2010/08/07/business/07chrysler.html?pagewanted=all.

12. Francine Lafontaine and Margaret Slade, "Exclusive Contracts and Vertical Restraints: Empirical Evidence and Public Policy," in *Handbook of Antitrust Economics*, ed. Paolo Buccirossi (Boston, MA: The MIT Press, 2008), 406–07.

13. For an extensive discussion of the benefits of independently owned dealerships, see Maryanne Keller and Kenneth Elias, "Consumer Benefits of the Dealer Franchise System," May 27, 2014, www.nada.org/GetTheFacts.

14. Richard L. Smith II, "Franchise Regulation: An Economic Analysis of State Restrictions on Automobile Distribution," *Journal of Law and Economics* 25, no. 1 (1982): 150.

15. See note 3 for exceptions.

16. McKinsey & Company, I*nnovating Automotive Retail: Journey Towards a Customer-Centric, Multiformat Sales and Service Network* (2014), refer to first unnumbered page titled, "Consider a few staggering facts about the changes in automotive retail."

17. Eric Cahill et al., "New Car Dealers and Retail Innovation in California's Plug-in Electric Vehicle Market" (working paper, University of California, Davis Institute of Transportation Studies, 2014), 6, http://www.its.ucdavis.edu/research/publications/publication-detail/?pub_id=2353. Cahill et al. find that "[Plug-in Electric Vehicle] buyers universally report lower satisfaction with the dealer purchase experience . . . [w]e found that on average, *plug-in vehicle buyers rated dealers much lower in sales satisfaction than conventional vehicle buyers* . . . in contrast, buyers ranked Tesla much more favorably."

18. Gerald R. Bodisch, "Economic Analysis Group Competition Advocacy Paper: Economic Effects of State Bans on Direct Manufacturer Sales to Car Buyers," EAG 09-1 CA (2009), US Department of Justice, Antitrust Division, 4.

19. Maryann Keller and Kenneth Elias, "Consumer Benefits of the Dealer Franchise System: An Examination of the Consumer Benefits of the Franchised New-Car Dealer System in the USA," (2014), 33.

20. John T. Delacourt, "New Cars and Old Laws: An Examination of Anticompetitive Regulatory Barriers to Internet Auto Sales," *Journal of Law, Economics, and Policy* 3, no. 155 (2007): 156–57.

21. See http://accessories.ford.com/?gnav=footer-owners for examples.

22. An Act concerning Vehicle Laws—Manufacturers, Distributors, and Factory Branches- Prohibited Acts, Md. Trans. Stat. Ann. § 15-207(e)(2)(ii) (LexisNexis 2014) (passed April 8, 2009).

23. Lafontaine and Morton, "State Franchise Laws," 240. Our count updates "Table A: Smith (1982) Summary of State Regulation in 1979, and Authors' 2009 update" found in the appendix. The count is updated by reviewing those three states without RMA laws in 2009: Arkansas, Indiana, and Maryland, to see if RMA laws have been codified since 2009. Maryland is the only state without RMA laws today.

24. Margaret E. Slade and Francine Lafontaine, "Franchising and Exclusive Distribution: Adaptation and Antitrust," in the *Oxford Handbook of International Antitrust Economics*, ed. Roger D. Blair and D. Daniel Sokol (Oxford, UK: Oxford University Press, 2014), 44.

25. Robert P. Rogers, "The Effect of State Entry Regulations on Retail Automobile Markets," Bureau of Economics, Staff Report to the Federal Trade Commission (January 1986), http://www.ftc.gov/sites/default/files/documents/reports/effect-state-entry-regulation-retail-automobile-markets/231955.pdf. WEFA Associates prepared a critique of the Rogers study for the National Automobile Dealers' Association. For a discussion of the WEFA critique and the FTC staff's response, see Deborah J. Holt, "Automobile Distribution Restrictions: An Economic Perspective," *Journal of Law, Economics, & Policy* 3, no. 2 (Spring 2007): 148–49.

26. Fiona Scott Morton et al., "Internet Car Retailing," *Journal of Industrial Economics* 49, no.4 (2001): 501–19. Larger Internet price savings accrue to customers who are less likely to bargain intensively, so the price savings do not simply mean that more price-conscious buyers gravitate toward the Internet. See Florian Zettelmeyer, Fiona Scott Morton, and Jorge Silvia-Russo, "Cowboys or Cowards: Why are Internet Car Prices Lower?" (working paper, National Bureau of Economic Research, 2001), http://www.nber.org/papers/w8667.

27. Lafontaine and Morton, "State Franchise Laws," 239.

28. Lafontaine and Morton, "State Franchise Laws," 239–40.

29. Gabe Nelson, "Ruling on Terminated Dealers Keeps Chrysler Case in the Courts," *Automotive News*, April 14, 2014, http://www.autonews.com/article/20140414/RETAIL/304149955/ruling-on-terminated-dealers-keeps-chrysler-case-in-the-courts.

30. American Arbitration Association, *A Report to Congress*, 4.The AAA did not note the terms of these cases withdrawn or settled.

31. Lafontaine and Morton, "State Franchise Laws," 246.

32. Gérard P. Cachon and Marcelo Olivares, "Drivers of Finished-Goods Inventory in the U.S. Automobile Industry," *Management Science* 56, no. 1 (January 2010): 211–12, http://dx.doi.org/10.1287/mnsc.1090.1095.

33. Haig Partners, "The Blue Sky Report, Mid-Year 2014," http://www.haigpartners.com/docs/midyearreport2014.pdf.

34. For a detailed analysis describing the political, economic, and social consequences of anticompetitive behavior, refer to Matthew Mitchell, "Pathologies of Privilege" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, July 2012), http://mercatus.org/publication/pathology-privilege-economic-consequences-government-favoritism.

35. See generally Keller and Elias, "Consumer Benefits of the Dealer Franchise System."

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Our mission is to generate knowledge and understanding of the institutions that affect the freedom to prosper and to find sustainable solutions that overcome the barriers preventing individuals from living free, prosperous, and peaceful lives. Founded in 1980, the Mercatus Center is located on George Mason University's Arlington campus.

Dynamic Competition, Online Platforms, and Regulatory Policy

Statement of Jerry Ellig, PhD
Senior Research Fellow Mercatus Center at George Mason University

Submitted to the House of Lords Select Committee on the European Union, EU Internal Market Sub-Committee
Call for Evidence: Online Platforms and the EU Digital Single Market

December 9, 2015

Thank you for the opportunity to share some insights about dynamic competition, online platforms, and regulatory policy.

I am an economist and research fellow at the Mercatus Center, a 501(c)(3) research, educational, and outreach center affiliated with George Mason University in Arlington, Virginia, USA. I have previously served as a senior economist at the Joint Economic Committee and as deputy director of the Office of Policy Planning at the Federal Trade Commission (FTC), a federal agency that implements both competition policy and consumer protection policy. While I was at the FTC from 2001 to 2003, the FTC's Office of Policy Planning led an extensive initiative that sought to remove barriers that protected established intermediaries from competition from new, online platforms.[1] That issue remains a research topic that several of my colleagues at the Mercatus Center and I have pursued extensively in the ensuing years.

The first fundamental question for policymakers in this area is defining the policy goal. I believe the appropriate goal of competition policy related to online platforms should be the promotion of consumer welfare—a concept rigorously defined in the economics literature. Consumer welfare is maximized when every unit of every resource is employed in the use that consumers value most highly.[2] Competition policy agencies in the United States typically regard consumer

[1] See, e.g., FTC, transcripts, "Public Workshop: Possible Anticompetitive Efforts to Restrict Competition on the Internet," Federal Trade Commission, October 8–10, 2002; *Possible Anticompetitive Barriers to E-Commerce: Wine*, Report from the Staff of the Federal Trade Commission, July 2003), available at https://www.ftc.gov/sites/default/files/documents/advocacy_documents/ftc-staff-report-concerning-possible-anticompetitive-barriers-e-commerce-wine/winereport2.pdf; Brief for the FTC as Amicus Curiae, *Powers v. Harris*, No. CIV-01-445-F (W.D. Okla. 2002) FTC and U.S. Department of Justice comments on Proposed North Carolina State Bar Opinions Concerning Non-Attorneys' Involvement in Real Estate Transactions (July 11, 2002), available at https://www.ftc.gov/sites/default/files/documents/advocacy_documents/ftc-and-department-justice-comment-north-carolina-state-bar-concerning-proposed-state-bar-opinions/nonattorneyinvolvment.pdf; and the collection of papers on barriers to electronic commerce in automobiles, caskets, wine, contact lenses, and real estate in the *Journal of Law, Economics & Policy* 3, no. 2 (2007), many of which are based on research that originated at the FTC.
[2] Dennis W. Carleton and Jeffrey M. Perloff, *Modern Industrial Organization* (New York: HarperCollins, 1994): 102–07.

welfare as the sole goal of competition policy.[3] Even if policymakers choose to pursue goals other than consumer welfare, they need to understand the impact of policies on consumer welfare so they can act with full information of the relevant tradeoffs.[4]

Economics provides the theoretical and empirical tools for identifying circumstances when markets fail to maximize consumer welfare and action by competition officials might improve consumer welfare. Unfortunately, conflicting policy prescriptions can sometimes emerge from static competition theory and dynamic competition theory. Since most online platforms are quite obvious examples of innovation, it is critical that decision makers understand the implications of both theories and take dynamic competition into account when making policy choices.

Static competition and perfect markets

Static competition is the type of competition theory most commonly found in economics textbooks. In a perfectly competitive market, numerous competitors with access to the same technology and resources, selling undifferentiated products or services, compete on price. In a perfectly contestable market, the complete absence of entry barriers means that numerous *potential* competitors force incumbent firms to behave as if they faced numerous actual competitors.[5] In both types of perfect markets, no firm has "market power"—the ability to profitably raise price above cost. In theory, a perfect market maximizes consumer welfare, given the state of technology, consumer preferences, and available resources.

"Perfect market" theories are thus at the root of competition authorities' concerns about market concentration and sunk costs that serve as barriers to entry or discourage customers from switching to a new platform. Unfortunately, the perfect market theories assume that there is no innovation and provide no way of explaining innovation. Since innovation clearly increases consumer welfare, competition authorities need to utilize theory and research on dynamic competition if they are to truly achieve the goal of promoting consumer welfare.

Dynamic competition and real markets

The most prominent concept of dynamic competition is associated with economist Joseph Schumpeter. Schumpeter suggested that "competition from the new commodity, the new technology, the new source of supply, the new type of organization . . . competition which commands a decisive cost or quality advantage and which strikes not at the margins of the profits and the outputs of the existing firms but at their foundations and their very lives" triggers the most significant advances in human well-being.[6]

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[3] Timothy J. Muris, "Antitrust Enforcement at the Federal Trade Commission: In a Word—Continuity" (speech before the American Bar Association Antitrust Section annual meeting, Chicago, Illinois, August 7, 2001), available at https://www.ftc.gov/public-statements/2001/08/antitrust-enforcement-federal-trade-commission-word-continuity.
[4] Jerry Brito and Jerry Ellig, "A Tale of Two Commissions: Net Neutrality and Regulatory Analysis," *CommLaw Conspectus* 16, no. 1 (2007): 15.
[5] William J. Baumol, John C. Panzar, and Robert D. Willig, *Contestable Markets and the Theory of Industry Structure* (New York: Harcourt Brace Jovanovich, 1982).
[6] Joseph A. Schumpeter, *Capitalism, Socialism, and Democracy* (New York: Harper, 1950): 84.

Other scholars have also developed dynamic theories of competition.[7] In evolutionary competition theories, different firms have different abilities, novelty constantly arises, innovation occurs as firms grow more experienced, and there are limits to the amount of information decision makers can acquire and process.[8] Evolutionary theorists believe that competition is an open-ended process of innovation, experimentation, and feedback, and the purpose of competition is to reveal what services, costs, and prices are possible.[9] The firms that survive and grow are those that better anticipate what consumers want and find the best ways to produce it.[10]

Strategic management scholars view competition as continuous striving to develop superior capabilities to serve consumers in cost-effective ways.[11] In a dynamically competitive market, some of the most important capabilities are the abilities to innovate, to change business strategy rapidly, to drop and add services in response to customer needs, to upgrade products with new technology and features, and to change prices as market conditions change.

In dynamic competition, the existence of market power does not necessarily harm consumer welfare. The firm that first introduces a cost-reducing or quality-enhancing technology, feature, or service can temporarily earn higher profits—until its success is imitated. Successful competitors appear to earn rents, or payments that exceed the opportunity costs of the resources the firm uses.[12] The prospect of earning these rents motivates firms to strive for superior performance, which benefits consumers.

Dynamic competition is especially noteworthy in the types of markets considered in the subcommittee's inquiry:

> In markets built largely upon binary code, the pace and nature of change has become hyper-Schumpeterian: unrelenting and unpredictable. New disruptions flow from many unexpected quarters as innovators launch groundbreaking products and services while devising new ways to construct cheaper and more efficient versions of existing technologies. Change has been constant, uneven, and highly disruptive but it has also led to the progress and innovation seen flowing through the information sector over the past two decades.[13]

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[7] Jerry Ellig and Daniel Lin, "A Taxonomy of Dynamic Competition Theories," in *Dynamic Competition and Public Policy*, ed. Jerry Ellig (Cambridge, UK: Cambridge University Press, 2001), 16.

[8] Ibid., 21.

[9] Richard R. Nelson, "The Tension Between Process Stories and Equilibrium Models: Analyzing the Productivity-Growth Slowdown of the 1970s," in *Economics as a Process: Essays in the New Institutional Economics, ed.* Richard N. Langlois (Cambridge, UK: Cambridge University Press, 1986), 135, 147.

[10] F. A. Hayek, "Competition as a Discovery Procedure," in *New Studies in Philosophy, Politics, Economics and the History of Ideas*, F. A. Hayek (Chicago: University of Chicago Press, 1978), 179–90; Israel M. Kirzner, *Discovery and the Capitalist Process* (Chicago: University of Chicago Press, 1985), 119–49; Israel M. Kirzner, *Competition and Entrepreneurship* (Chicago: University of Chicago Press, 1973).

[11] Jay B. Barney, "Competence Explanations of Economic Profits in Strategic Management: Some Policy Implications," in *Dynamic Competition and Public Policy*, Ellig, 45.

[12] Harold Demsetz, "Industry Structure, Market Rivalry, and Public Policy," *Journal of Law & Economics* 16, no. 1 (1973): 1–9.

[13] Brent Skorup and Adam Thierer, "Uncreative Destruction: The Misguided War on Vertical Integration in the Information Economy," *Federal Communications Law Journal* 65, no. 2 (2013): 180.

Regulatory implications of dynamic competition research

Dynamic competition is not just about price. In some cases, price may be a less important factor than various aspects of quality or performance. Performance, rather than price, might be the relevant attribute for identifying whether different service providers are in the same market or determining whether a firm has market power.[14] Control over differentiated content can be a key aspect of competition,[15] rather than a threat to competition.

Business practices that appear to be restrictive, discriminatory, or an attempt to "lock in" customers can create consumer benefits by enhancing performance. For example, Apple's iPhones and iPads are "walled gardens" that restrict the services and apps allowed on the platform. The iPhone and iPad have been tremendously successful in part because Apple's closed system allows it to ensure that services are intuitive, seamless, and less vulnerable to viruses and malware.[16] Consumers willingly choose to use these restricted platforms even though other options exist. "Openness is not necessarily always good for competition, nor are closed systems always bad."[17] Most empirical research finds that vertical restrictions voluntarily adopted by business firms tend to enhance, rather than harm, efficiency and consumer welfare.[18] For this reason, restrictive business practices that competition authorities suspect harm consumers should be subject to an evidence-based "rule of reason" analysis that considers both benefits and costs to consumers, rather than a per se prohibition.

Market power need not harm consumer welfare. Profits that appear to be "mere rents" may actually be a risk premium or a return on the successful firm's investment in unique capabilities. Business practices that at first glance appear merely to transfer wealth from consumers to incumbent firms may actually be the means by which the firm collects its reward for successful innovation. Dynamic competition theory suggests that such practices should be given the benefit of the doubt if they do not demonstrably reduce economic efficiency.

Dynamic competition has the potential to reduce the significance of sunk costs as a barrier to entry. In dynamically competitive markets with heterogeneous firms, innovation allows new entrants to overcome some of the incumbent's sunk cost advantage.[19] If a new entrant can

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[14] Christopher Pleatsikas and David Teece, "New Indicia for Antitrust Analysis in Markets Experiencing Rapid Innovation," in *Dynamic Competition and Public Policy*, Ellig, 95.

[15] Alex Chisholm, chief executive, UK Competition and Markets Authority, "Platform Regulation—Antitrust Law versus Sector-Specific Legislation: Evolving Our Tools and Practices to Meet the Challenges of the Digital Economy" (speech presented at the Bundesnetzagentur conference, Bonn, Germany, October 27, 2015), 8 of printed HTML version.

[16] Skorup and Thierer, "Uncreative Destruction," 169.

[17] Chisholm, "Platform Regulation" 3 of printed HTMLversion.

[18] Francine Lafontaine and Margaret Slade, "Exclusive Contracts and Vertical Restraints: Empirical Evidence and Public Policy," in *Handbook of Antitrust Economics*, ed. Paolo Buccirossi (Boston: MIT Press, 2008), 391—414.

[19] The economic theory that posits sunk costs to be entry barriers assumes that both incumbents and potential entrants have access to the same technology, so that all can produce at the same total cost. As two of the theory's developers noted, "By entailing the complete absence of barriers to entry, perfect contestability, again like perfect competition, threatens to rule out entirely the reward mechanism that elicits the Schumpeterian innovative process. This mechanism, as we have seen, rests on the innovator's supernormal profits, which are permitted by the temporary possession of monopoly power flowing from priority in innovation. Since perfect contestability rules out all market power . . . the market mechanism's main reward for innovation is destroyed by that market form."

provide service comparable to the incumbent's at a lower total cost, or if the entrant can offer new performance features that are valuable to consumers, then entry can occur despite the presence of sunk costs. Examples abound of dominant platforms, sometimes created with substantial sunk costs, that sunk into oblivion when faced with new competition. These include smartphones, smartphone operating systems, Internet service providers, social networking sites, instant messaging platforms, web portals, web browsers, and numerous types of software.[20] "MySpace and Bebo, if you remember them, serve as useful reminders of how short-lived perceived dominance can be."[21] Since entry barriers in the form of sunk costs are less problematic due to dynamic competition, their existence is not a reliable indicator of whether a firm has market power.

Government-created entry barriers are still suspect. There is one form of barrier to entry that dynamic competition has great difficulty overcoming: government-granted protection and privileges to incumbent firms. When entry is prohibited, superior efficiency alone does not enable a new competitor to enter a market. Short of outright prohibitions, regulations that raise rivals' costs can also prevent innovative firms from entering new markets.[22] UK Competition and Markets Authority Alex Chisholm recently noted the example of the European Court of Justice's "right to be forgotten" ruling, which could curtail competition by imposing substantial compliance costs that smaller companies and potential entrants cannot afford.[23] In a wide variety of industries, established firms advocate regulation of new online platforms simply to prevent or forestall competition from these competitors that offer lower costs, greater variety, greater convenience, or other consumer benefits. (In the United States, this has occurred in industries as diverse as taxis, hotels, restaurants, auctions, automobiles sales, caskets, wine, contact lenses, legal services, and real estate.[24]) For these reasons, the type of barrier to entry that poses the most significant threat to dynamic competition is government-imposed restrictions on entry. Competition authorities should scrutinize government-created entry barriers and seek to remove them via legal action or competition advocacy if the entry barrier creates no social benefit commensurate with its cost in terms of consumer welfare.[25]

Mandated sharing or "openness" regulations could create monopolies. Competition authorities should also view with skepticism any calls to impose sharing or "openness" requirements on

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William J. Baumol and Janusz A. Ordover, "Antitrust: Source of Dynamic and Static Inefficiencies?," in *Antitrust, Innovation, and Competitiveness*, eds. Thomas M. Jorde and David J. Teece (New York: Oxford University Press, 1992), 85.

[20] On smartphones, smartphone operating systems, and Internet service providers, see Skorup and Thierer, "Uncreative Destruction," 176–79, 185. On social networking, web portals, and instant messaging, see Adam Thierer, "The Perils of Classifying Social Media Platforms as Public Utilities," *CommLaw Conspectus* 21, no. 1 (2013): 274–78, 288. On web browsers and software, see Stan Liebowitz and Stephen E. Margolis, "Network Effects and the Microsoft Case," in *Dynamic Competition and Public Policy*, ed. Ellig, 160–92.

[21] Chisholm, "Platform Regulation," 5 of printed HTML version.

[22] Christopher Koopman, Matthew Mitchell, and Adam Thierer, "The Sharing Economy and Consumer Protection Regulation: The Case for Policy Change" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, December 2014), 7–8.

[23] Chisholm, "Platform Regulation," 5 of printed HTML version.

[24] See the references cited in footnote 1 above.

[25] Numerous examples of FTC competition advocacy letters and amicus briefs dealing with regulatory barriers to competition from online platforms are available at "Advocacy," Federal Trade Commission website, https://www.ftc.gov/policy/advocacy.

dominant platforms. Various commentators have argued that some type of sharing or openness regulation is appropriate for Facebook, Google, eBay, Twitter, and Amazon because network externalities make them natural monopolies or close to it. Such calls are grounded in speculation that the dominant platform may become a monopoly, but monopolization can become a self-fulfilling prophecy when requirements for sharing or openness discourage competitors from building their own platforms.[26]

Ex post antitrust enforcement will often be superior to ex ante regulation. Dominance does not necessarily harm consumers; seemingly restrictive practices can enhance competition; and innovative markets change rapidly. Under these circumstances, ex post enforcement—based on case-specific empirical analysis to determine whether consumers have been harmed—can better protect competition and consumers than ex ante prohibitions based on projections of the potential for harm.[27] If MySpace, for example, had been subjected to public utility regulation because of its temporary market dominance, it is quite possible that competitors like Facebook and LinkedIn would never have emerged, because the potential for regulation would have diminished the profit potential from successfully challenging MySpace.

I hope this brief summary will prove useful to the subcommittee in its inquiry. I would be happy to address any questions you may have as you proceed.

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[26] Thierer, "The Perils of Classifying Social Media Platforms," 269.

[27] "The significant risks associated with premature, broad-brush ex ante legislation or rule-making point towards a need to shift away from sector-specific regulation to ex post antitrust enforcement, which is better adapted to the period we're in, with its fast-changing technology and evolving market reactions." Chisholm, "Platform Regulation," 2 of printed HTML version.