MERCATUS ON POLICY

Trouble Brewing? Brewer and Wholesaler Laws Restrict Craft Breweries

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September 2016

MERCATUS CENTER
George Mason University

Over the past 35 years, the number of breweries operating in the United States increased from 92 in 1980 to an all-time high of 4,144 in 2015.[1] This growth in the number and variety of breweries has been driven by the craft brewing industry and has provided consumers with a vastly increased array of choices.[2] The growth in the craft beer industry has not been proportional across all states, however. While many factors influence the growth of craft breweries,[3] regulations that restrict how brewers can sell their own beer have inhibited growth in many states and have limited consumer choices on the shelf and at the tap.

This essay describes how self-distribution laws and beer franchise laws have impacted the growth of the craft brewing industry. Many states' distribution laws do not allow brewers to self-distribute and deliver their beer directly to a retailer, but mandate that brewers sell through independent wholesalers. On top of this, beer franchise laws limit when brewers can terminate contracts with wholesalers. These laws have significant effects on the number of brewers and amount of craft beer produced. States that allow self-distribution and do not enact beer franchise laws consistently have more breweries, creating more choices for consumers.

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THE THREE-TIER SYSTEM AND SELF-DISTRIBUTION

After the Twenty-First Amendment repealed Prohibition in 1933, each state implemented its own set of regulations for the alcoholic beverage industry.

Most states established a three-tier system that mandates—to varying degrees in different states—separations of brewers (first tier), distributors or wholesalers (second tier), and retailers (third tier). Under the strictest form of this system, each tier must be independently owned and operated, and integration between tiers is not allowed, meaning brewers cannot sell directly to consumers or retailers. The economic term for this type of restriction is a "vertical restraint," as it restricts how firms up and down the supply chain interact.

In many states, the three-tier system does not allow brewers to sell their beer directly to retailers, but instead requires brewers to use independent wholesalers to sell to retailers. This undermines brewer autonomy as it forces brewers to turn over their product to an independent company for distribution to retailers. Many states have passed exceptions to these laws for small brewers that produce below a yearly limit, but these limits are often low and end up creating a disincentive to growth. Craft brewers that have the potential to outgrow the small-brewer exception, but do not want to be forced to work with wholesalers, might intentionally avoid expanding their operations beyond the distribution limit.

In fact, craft brewers have long advocated for the legal right to distribute their own product. For example, Red Oak Brewery, a craft brewery located in Whitsett, NC, has fought unsuccessfully against North Carolina's distributions laws, which require a brewery to use wholesalers for all of its distribution if it produces more than 25,000 barrels of beer per year.[4] Many states have even more restrictive barrel limits than North Carolina, and 14 states do not allow any brewers, regardless of production volume, to distribute their own products.[5]

BEER FRANCHISE LAWS

In the 1970s states began to enact beer franchise laws, another vertical restraint, which regulate contracts between brewers and wholesalers. While the relationship between a brewer and a wholesaler is not necessarily a traditional franchise, beer franchise laws regulate the brewer-wholesaler relationship much like state laws govern more traditional franchises.[6] Beer franchise laws put legal restrictions on when a brewer can cancel, terminate, or fail to renew a contract with a wholesaler. A typical beer franchise law requires the brewer to demonstrate good cause, as defined in the law, before termination or nonrenewal of a contract is allowed. Some laws include further restrictions, such as granting the wholesaler an exclusive territory in which no other wholesaler can sell the contracted brands to retailers.

Almost all states have some form of beer franchise laws. In effect, these laws make it very difficult for a brewer to switch to a different wholesaler. Even if a brewer can demonstrate good cause, many laws provide another level of protection for wholesalers by requiring advanced notice and a period, often 60 or 90 days, in which the wholesaler is allowed to address the grievance before termination or nonrenewal is allowed.[7]

These franchise laws have large economic and financial consequences for brewers stuck in contracts with wholesalers that are not performing well.[8] One example of an expensive dispute between a brewer and wholesaler is that of Bell's Brewery in Kalamazoo, MI, and its Chicago wholesaler, National Wine and Spirits (NWS). In 2006, NWS planned to sell the rights to distribute Bell's brands to another wholesaler. Bell's opposed the sale, worrying its products would be ignored by the new wholesaler. Rather than engaging in a costly legal battle to end the wholesaler contract, Bell's pulled distribution of its beer out of the entire state of Illinois, despite the Illinois market comprising over 10 percent of the brewery's sales.[9] Exiting the state was one of the few ways Bell's could legally end its contract with NWS.[10] Bell's returned distribution to Illinois nearly two years later—after NWS lost its wholesale license and there was no longer a threat of a lawsuit.

STATE EXPERIENCES

Restricting a brewer's right to distribute its own product leads to considerably fewer breweries. Figure 1 shows data from the Alcohol and Tobacco Tax and Trade Bureau (TTB) that compares the number of breweries per million people in states that allow craft brewers to distribute their own beer versus states that do not. In 2013, states that allowed self-distribution had an average of 20.34 breweries per million people, while states that prohibited self-distribution averaged only 9.30 breweries per million people. A recent economic and statistical analysis of the data shows that approximately 58 to 76 percent of this difference can be explained by self-distribution laws.[11] Production volume by craft brewers was also found to be 152 percent to 182 percent higher in states with no distribution restrictions.

Like self-distribution laws, beer franchise laws are not only harmful to existing breweries, but they also limit new, entering breweries. Figure 2 shows data from the TTB on the number of breweries in states that have beer franchise laws versus states that do not. In 2013, states without beer franchise laws averaged 21.91 breweries per million people—far more than the 15.94 breweries per million people in states with franchise laws. Statistical analysis in the same study shows that implementation of beer franchise laws greatly contributes to this difference and causes a significant reduction in the entry rate and beer production of craft brewers.[12] Further, this effect is even larger in states that do not allow self-distribution. This intuitively makes sense, as brewers located in states that allow self-distribution can avoid the costly problems franchise laws can cause by distributing their own beer. Brewers located in states that do not allow self-distribution do not have this option, so franchise laws dampen production and new brewery openings even more in these states.

CONCLUSION

Why do beer franchise laws exist, and who benefits from them? Beer wholesalers claim these laws protect them and the market from larger breweries, such as AB InBev and MillerCoors, which might force wholesalers to limit market access to craft breweries.[13] Thus, wholesalers argue that these laws protect consumer interests and improve brewer access to the market. Although large breweries could theoretically influence the supply chain in such a way,[14] it does not make sense to apply these laws to restrict craft brewers that are unlikely to be large enough to cause similar concerns. Even still, the evidence is contrary to the claim that these restrictive laws protect consumer interests. California both allows self-distribution and has no beer franchise laws, and consumers suffer no dearth of brewery choice—the Brewers Association reports California had 518 breweries in 2015,[15] the highest number in the United States. And California is just one example. States that give brewers more control over their own product consistently have more breweries, and consumers in those states have never had more choices.

In addition to the research described above, these types of vertical restraints have been studied in a variety of contexts and settings. In a recent survey of empirical studies investigating vertical restraints, economists Margaret Slade and Francine Lafontaine concluded, "When restraints and contract limitations are imposed on manufacturers via government intervention, often in response to dealer pressure due to perceptions of uneven bargaining power between manufacturers and dealers, the effect is typically to reduce consumer well-being as prices increase and service levels fall."[16]

The evidence clearly shows that neither craft brewers nor consumers benefit from laws that limit the control brewers have over their growth or the distribution of their products. To promote consumer choice in the brewing industry, regulations that restrict brewer control should be repealed or altered to put the control back in brewers' hands.

NOTES

1. Brewers Association, "The Year in Beer: U.S. Brewery Count Reaches All-Time High of 4,144," December 2, 2015.
2. The Brewers Association describes craft brewers as "small, independent, and traditional." Small means an "annual production of 6 million barrels of beer or less (approximately 3 percent of US annual sales). Beer production is attributed to the rules of alternating proprietorships." Independent means that "less than 25 percent of the craft brewery is owned or controlled (or equivalent economic interest) by an alcoholic beverage industry member that is not itself a craft brewer." And traditional signifies "a brewer that has a majority of its total beverage alcohol volume in beers whose flavor derives from traditional or innovative brewing ingredients and their fermentation. Flavored malt beverages (FMBs) are not considered beers." Brewers Association, "Craft Brewer Defined," accessed September 1, 2016.
3. Glenn R. Carroll and Anand Swaminathan, "Why the Microbrewery Movement? Organizational Dynamics of Resource Partitioning in the U.S. Brewing Industry," *American Journal of Sociology* 106, no. 3 (2000): 715–62.
4. Red Oak Brewery, "Freeing Bier!," accessed September 1, 2016.
5. These states are Alabama, Delaware, Florida, Georgia, Kansas, Kentucky, Louisiana, Mississippi, Missouri, Nebraska, Nevada, South Carolina, South Dakota, and Virginia. See Jacob Burgdorf, "Trouble Brewing? Impact of Mandated Vertical Restraints on Craft Brewery Entry and Production" (working paper, Department of Economics, University of Louisville, 2016), https://sites.google.com/site/jeburgdorf/research.
6. Barry Kurtz and Bryan H. Clements, "Beer Distribution Law as Compared to Traditional Franchise Law," *Franchise Law Journal* 33, no. 3 (2014): 397.
7. Va. Code § 4.1-506 (2014) is representative of this type of law. It requires at least 90 days of notice before termination and allows 60 days for the wholesaler to correct the grievance.
8. Steve Hindy, "Free Craft Beer!," *New York Times*, March 29, 2014.
9. Mike Hughlett, "Bell's Brings Beer Back to Area," *Chicago Tribune*, August 1, 2008.
10. Nicholas Day, "Bye-Bye Bell's," *Chicago Reader*, December 14, 2006.

11. Burgdorf, "Trouble Brewing? Impact of Mandated Vertical Restraints on Craft Brewery Entry and Production."

12. Ibid.

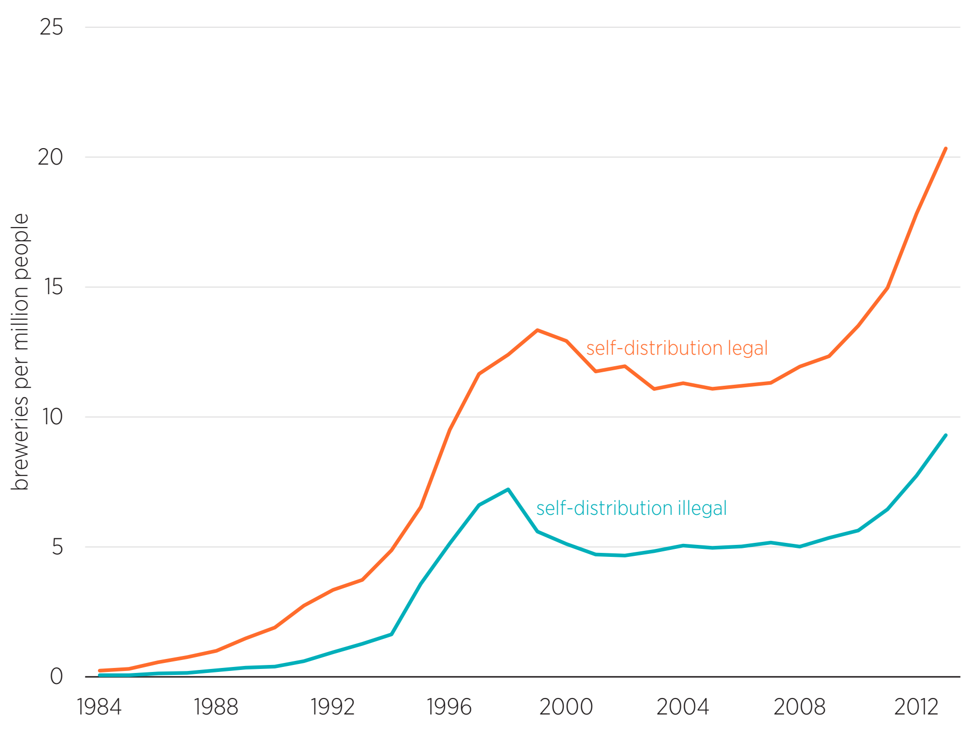
13. Specifically, the National Beer Wholesalers Association claims, "Beer franchise laws prohibit brewers from terminating distributors for taking on new brands. Beer franchise laws inhibit forced consolidation and termination without cause. Combined with three-tier requirements, franchise laws prohibit vertical integration of the brewing, distribution and retail tiers, preventing monopolies." National Beer Wholesalers Association, "Benefits of Beer Franchise Laws," accessed September 1, 2016.

14. John Asker and Heski Bar-Isaac, "Raising Retailers' Profits: On Vertical Practices and the Exclusion of Rivals," *American Economic Review* 104, no. 2 (2014): 672–86.

15. Brewers Association, "Craft Beer Sales by State: California," accessed September 1, 2016.

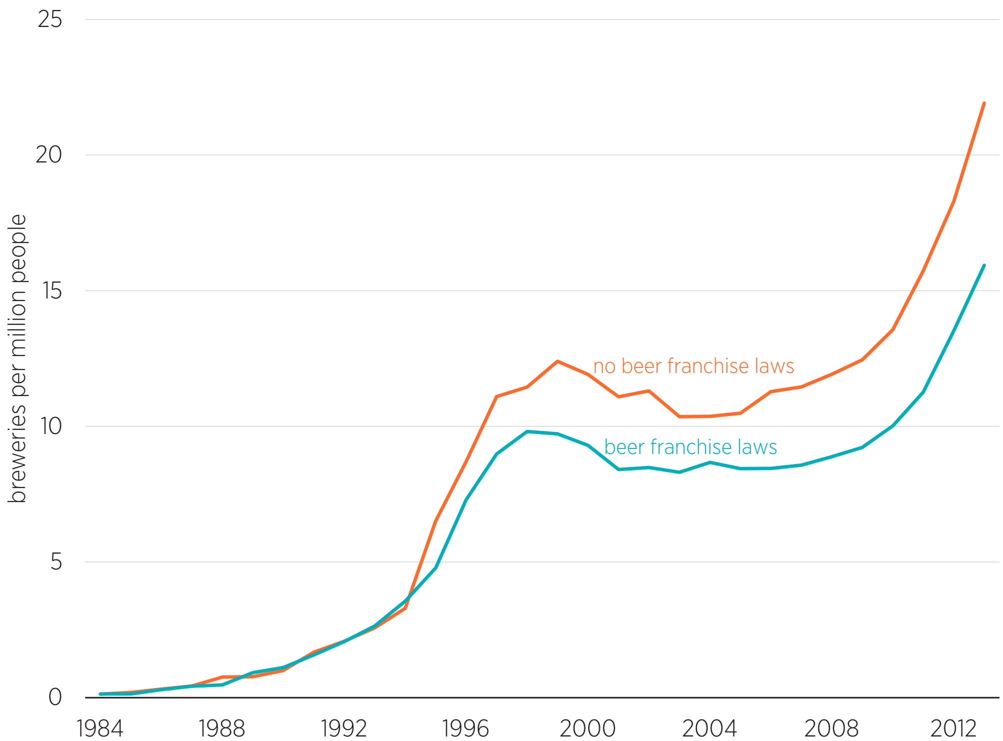
16. Francine Lafontaine and Margaret Slade, "Exclusive Contracts and Vertical Restraints: Empirical Evidence and Public Policy," in *Handbook of Antitrust Economics*, ed. Paolo Buccirossi (Cambridge, MA: MIT Press, 2008), 391–414.

FIGURE 1. BREWERIES PER MILLION PEOPLE IN STATES WITH AND WITHOUT SELF-DISTRIBUTION RESTRICTIONS



Source: Alcohol and Tobacco Tax and Trade Bureau and author's research of the legal histories of each state.

FIGURE 2. BREWERIES PER MILLION PEOPLE IN STATES WITH AND WITHOUT BEER FRANCHISE LAWS



Source: Alcohol and Tobacco Tax and Trade Bureau and author's research of the legal histories of each state.