

# MERCATUS ON POLICY

## Bottling Up Innovation in Craft Brewing: A Review of the Current Barriers and Challenges

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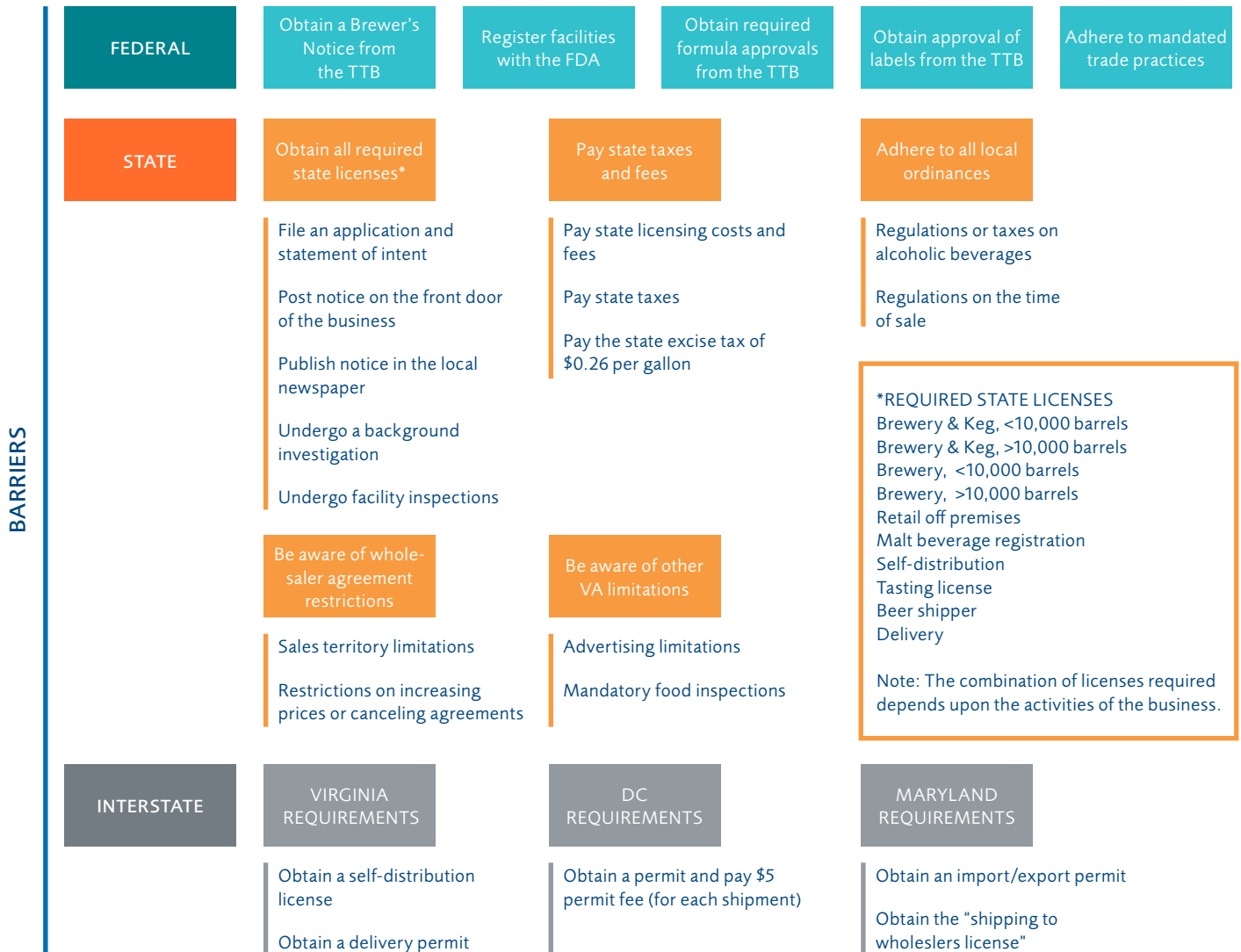
**"B**UILD A BETTER mousetrap," the old saying goes, "and the world will beat a path to your door." Brew a better beer, however, and regulators will tie your door shut with red tape. Startups in the craft brewing industry face formidable barriers to entry in the form of federal, state, and local regulations. These barriers limit competition and innovation, reducing consumer welfare.

While customers and new entrants are harmed, these regulations can be a privilege to incumbent firms and industries. There are various political and historical reasons for the persistence of these rules, despite the fact that they lack economic justification. Policymakers interested in economic development should eliminate regulations to help firms overcome confusing and unnecessary barriers to entry and to level the playing field between established firms and their newer, smaller rivals.

### A SURVEY OF SELECTED REGULATORY BARRIERS TO ENTRY

ALL ENTREPRENEURS FACE entry costs, regardless of the industry they seek to enter. Some of these costs are inherent to business, such as those related to developing a business plan, raising capital, and bringing the product to market. Other costs are the result of regulations that—while imposed on all firms—tend to be more burdensome for newer and smaller operators.<sup>1</sup> A series of regulations increase the cost of developing, producing, and distributing new products in the brewing industry, including the "three-tier system" and an assortment of licensing and permitting laws.

FIGURE 1: BARRIERS TO STARTING A CRAFT BREWERY IN VIRGINIA



Sources: Alcohol and Tobacco Tax and Trade Bureau [www.ttb.gov](http://www.ttb.gov); Virginia ABC [www.abc.virginia.gov](http://www.abc.virginia.gov); Virginia State Code [leg1.state.va.us](http://leg1.state.va.us).

Following the repeal of prohibition in 1934, nearly every state passed laws to mandate “three-tier” distribution systems that persist today.<sup>2</sup> But for certain limited exceptions, these systems require that suppliers, wholesalers, and retailers (stores, restaurants, etc.) remain separate entities according to their ownership and management. Many of these state laws require that distributors be granted exclusive territories, making a particular wholesaler the exclusive source for a specific brand within a defined area. Further, as of 2003, all but four states have franchise laws that dictate how suppliers may contract with distributors and on what terms a supplier may choose to work with another distributor.<sup>3</sup> In a recent survey of the empirical literature on laws that limit or

constrain the relationship between buyers and sellers in a supply chain, economists Francine Lafontaine and Margaret Slade found that “when restraints are mandated by the government, they systematically reduce consumer welfare or at least do not improve it.”<sup>4</sup>

As figure 1 demonstrates, there are a number of federal and state permits and authorizations with which brewers must comply before they can bring their product to market. We find that an entrepreneur attempting to enter the brewing market in Virginia must complete at least five procedures at the federal level, five procedures at the state level, and—depending on the locality—multiple procedures at the local level.<sup>5</sup>

An aspiring brewer must first obtain approval for a Brewer's Notice from the Alcohol and Tobacco Tax and Trade Bureau (TTB), a division of the US Department of the Treasury.<sup>6</sup> This process may include background checks, field investigations, examination of equipment and premises, and legal analysis of proposed operations.<sup>7</sup> She must then obtain a license (and potentially other authorizations) from the alcoholic beverage regulator in the state where she plans to operate her brewery and sell her beers to wholesalers.<sup>8</sup> In Virginia, for example, this license can be refused if the state believes the brewer is "physically unable to carry on the business," is not a person of "good moral character and repute," fails to demonstrate the "financial responsibility sufficient to meet the requirements of the business," or is unable to "speak, understand, read and write the English language in a reasonably satisfactory manner."<sup>9</sup> The state may even refuse to grant a license if it feels that there are enough brewers in the locality and an additional brewer would be "detrimental to the interest, morals, safety or welfare of the public."<sup>10</sup>

Before her first bottle can be sold, the brewer must also obtain approval for her beer label from the TTB and register that same label in states where she plans to sell it.<sup>11</sup> Depending on her ingredients and brewing methods, she may also need approval from the TTB for her formula as well.<sup>12</sup> Once she is in business, the brewer must ensure that her ingredients and brewing methods comply with regulations enforced by TTB, the Food and Drug Administration, and—in the case of organic beers—the US Department of Agriculture.<sup>13</sup> In addition, how the brewer, wholesaler, and retailer market beer is subject to federal and state regulation.

Throughout this process, the brewer will face wait times and fees that add to the cost of entering and competing in the market. To obtain her Brewer's Notice from the TTB, she must wait approximately 100 days.<sup>14</sup> To receive approval for her formula, she could wait an additional 60 days.<sup>15</sup> And to receive approval for her label, she could wait another 17 days.<sup>16</sup> With regard to fees, the state brewery license will cost \$350 if she brews fewer than 500 barrels of beer in one year, \$2,150 if she brews between 501 and 10,000 barrels in one year, or \$4,300 if she brews more than 10,001 barrels.<sup>17</sup>

In aggregate, the number of regulatory procedures that we identify (12), the wait times to complete many of these procedures (in excess of 100 days), and the associated costs (e.g., \$2,150 for a single license) represent formidable barriers to entry. All of these barriers are in

addition to the standard regulatory hurdles that all small businesses must surmount (zoning ordinances, incorporation rules, and tax compliance costs). This means that starting a microbrewery in the state of Virginia requires as many procedures as starting a small business in China or Venezuela, countries notorious for their excessive barriers to entry.<sup>18</sup>

## A TRAGEDY OF THE ANTICOMMONS

A BREWER MUST comply with regulations enforced by several regulators at each of several levels of government. For example, at just the federal level, regulators include the TTB, the FDA, and the USDA. With multiple regulators at each level of government possessing the ability to restrict the entry of new business, the pattern of regulation is characteristic of what has become known as the "tragedy of the anticommons."<sup>19</sup>

In the traditional "tragedy of the commons," multiple parties have the ability to *access* a common resource and, if each party fails to account for the cost his use imposes on the others, the resource tends to be overutilized.<sup>20</sup> In contrast, a "tragedy of the anticommons" arises when multiple parties have the ability to *exclude access* to a resource through taxation, regulation, or other means.<sup>21</sup> This tends to lead to underutilization of the resource or underdevelopment of the market.

While this concept is relatively novel, it helps explain old problems. For example, trade along the Rhine River during the Middle Ages was stifled due to an anticommons. After the fall of the Holy Roman Empire, a series of local barons began exacting tolls for the use of the Rhine River. Each baron acted independently, failing to account for the fact that his toll diminished the tax base on which other barons levied their own tolls.<sup>22</sup> As a result, economic activity along the river declined, and everyone suffered—including the barons.<sup>23</sup> In time, these overlapping taxers came to be known as "robber barons."

Like these robber barons, several overlapping entities at the local, state, and federal level have the ability to exclude access to the craft brewing market through taxation and regulation. Further, the political interests motivating the actions of each regulator are distinct from one another, diminishing the likelihood that any one regulator will account for the actions of the others. For example, those who advocate for tighter local zoning ordinances are typically not the same as those who advocate for more exacting TTB brewing standards,

and those that advocate for greater FDA restrictions on food safety are rarely the same as those who advocate for greater restrictions on the sale and distribution of alcoholic beverages. With so many regulators, each motivated by distinct interests, no one is incentivized to account for the cumulative effect.

## BOOTLEGGERS, BAPTISTS . . . AND BREWERS

ECONOMIST BRUCE YANDLE offers another theory of regulation which explains the existence and maintenance of so many regulatory burdens in the brewing industry. Known as the “Bootlegger and Baptist” theory of regulation, it draws its name from states’ efforts to restrict the sale of alcoholic beverages on Sundays.<sup>24</sup> The Baptists, Yandle asserts, endorsed Sunday sales bans on moral grounds and provided vocal support for the promised public benefits that would result from these restrictions. The bootleggers, who offered financial and political support for these same restrictions, supported them in an effort to reduce competition. The result was a coalition of two distinct groups that supported these regulations for vastly different purposes.

Applying this theory to the three-tier system, the stated intent was to limit the ability of producers to sell directly to consumers and thus to prevent undue influence and control of one market player over another, which many blamed as a root cause for various social maladies of the pre-Prohibition era.<sup>25</sup> However, the practical effect of these regulations has been to increase the market power of wholesalers.<sup>26</sup> As a result, distributors are able to claim a considerable share of the economic benefit that would otherwise flow to the brewer or consumer.<sup>27</sup> While initially justified on public interest grounds, the three-tier system has created an entrenched interest (distributors) that now has a financial stake in seeing that these policies persist.

Limiting the ability of producers to both sell and promote alcohol directly to consumers was the historical social justification for the current regulations, but now there are also incumbents and more established firms that gain financially from the maintenance of these regulations. Even though many of the regulations surveyed above (licensing, permitting, prior agency approval for formulas, etc.) raise costs on all firms regardless of their size, the costs of compliance tend to be particularly burdensome for newer and smaller operators.<sup>28</sup> That means many large, established firms benefit from these rules since they raise their rivals’ costs.<sup>29</sup>

## SIMPLIFY, DON'T SUBSIDIZE

IN AN EFFORT to help small craft brewers overcome these regulatory burdens, many politicians have proposed targeted assistance for small or new craft brewers. For example, New York has chosen to create a special license for “farm breweries” that allows them to operate with fewer regulatory restrictions.<sup>30</sup> Similarly, policymakers in Illinois have created specific regulatory exemptions targeted at smaller brewers.<sup>31</sup> Other states, such as North Carolina, provide subsidies and grants to help brewers “compete” in the market.<sup>32</sup> These targeted privileges, however, create their own set of inequities and inefficiencies, encouraging resource wastage through rent-seeking and unproductive entrepreneurship.<sup>33</sup> Moreover, they are policy solutions to a policy-created problem.

Instead, policymakers should focus on more direct, effective, and less problematic solutions to reduce the tangle of regulatory burdens encountered by craft brewers. Eliminating regulatory burdens for all firms would allow brewers to succeed or fail on the basis of their ability to provide the greatest value to consumers at the lowest cost to society.

## ENDNOTES

1. Matthew Mitchell, “Pathology of Privilege: The Economic Consequences of Government Favoritism” (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, July 8, 2012), 8.
2. For more information, see Douglas Glen Whitman, *Strange Brew: Alcohol and Government Monopoly* (Oakland, CA: The Independent Institute, 2003).
3. *Ibid.*, 8 (every state but Alaska, Colorado, DC, New Jersey, and Oklahoma has such laws).
4. Francine Lafontaine and Margaret E. 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.
5. Data on file with authors and available upon request.
6. 27 U.S.C. § 204 (2014).
7. Alcohol and Tobacco Tax and Trade Bureau, US Department of Treasury, “Days to Process Permits Online Original Applications,” accessed May 6, 2014, <http://www.ttb.gov/nrc/average-days.shtml>.
8. See, for example, VA Code Ann. § 4.1-208 (2014).
9. VA Code Ann. § 4.1-222 (2014).
10. *Ibid.*

11. See 27 C.F.R. § 25.142 (2014); see also 27 C.F.R. § 25.141 (2014).
12. See 27 C.F.R. § 25.142 (2014); see also 27 C.F.R. § 25.141 (2014).
13. See, for example, 27 C.F.R. § 25.55 (2014); see also the Food and Drug Administration Amendments Act of 2007, the Public Health Security and Bioterrorism Preparedness and Response Act (Bioterrorism Act of 2002), the Food Allergen Labeling and Consumer Protection Act of 2004, and the Food Safety Modernization Act of 2010.
14. Alcohol and Tobacco Tax and Trade Bureau, "Days to Process Permits."
15. Alcohol and Tobacco Tax and Trade Bureau, "Processing Times for Beverage Alcohol Formulas," accessed May 6, 2014, <http://www.ttb.gov/formulation/processing-times.shtml>.
16. *Ibid.*
17. VA Code Ann. § 4.1-231(A)(3)(a) (2014).
18. Simeon Djankov et. al., "The Regulation of Entry," *The Quarterly Journal of Economics* 117, no. 1 (2002): 18–20, [http://scholar.harvard.edu/files/shleifer/files/reg\\_entry.pdf](http://scholar.harvard.edu/files/shleifer/files/reg_entry.pdf).
19. Michael Heller, "The Tragedy of the Anticommons: Property in the Transition from Marx to Markets," *Harvard Law Review* 111 (1998): 621–88; James Buchanan and Yong Yoon, "Symmetric Tragedies: Commons and Anticommons," *Journal of Law and Economics* 43 (2000): 1; see also Matthew Mitchell and Thomas Stratmann, "Wireless Taxes and Fees: A Tragedy of The Anticommons" (Working Paper No. 12-06, Mercatus Center at George Mason University, Arlington, VA, January 23, 2012).
20. Garrett Hardin, "The Tragedy of the Commons," *Science* 162 (1968): 124–48.
21. Michael Heller, *The Gridlock Economy: How Too Much Ownership Wrecks Markets, Stops Innovation, and Costs Lives* (New York: Basic Books, 2008): 3.
22. Mitchell and Stratmann, "Wireless Taxes and Fees," 10.
23. *Ibid.*
24. See Bruce Yandle, "Bootleggers and Baptists: The Education of a Regulatory Economist," *Regulation* (May/June 1983): 12–16; see also Bruce Yandle, "Bootleggers and Baptists in Retrospect," *Regulation* (Fall 1999): 5–7.
25. Whitman, *Strange Brew*, 1.
26. Many attributed the overconsumption of the pre-Prohibition era to be the result of excessive promotion by the alcohol suppliers and retailers, which in many cases were one and the same. Whitman, *Strange Brew*, 1 and 3.
27. *Ibid.*
28. Mitchell, "Pathology of Privilege," 8.
29. Steven C. Salop and David T. Scheffman, "Raising Rivals' Costs," *The American Economic Review* 73 (1983): 267–271.
30. Governor Andrew M. Cuomo, "Governor Cuomo Welcomes 14 Licensed Farm Breweries in New York State," news release, October 9, 2013, <http://www.governor.ny.gov/press/10092013-licensed-farm-breweries>.
31. 235 Ill. Comp. Stat. Ann 5/3-12(a)(18)(A) (2014).
32. Jon Sanders, *Rights and Regulations Update* (blog), "Beer Politics in N.C.; Or, Why I Prefer Refreshing Reg Lite to Stale Old Cronyism," accessed May 6, 2014, <http://www.johnlocke.org/newsletters/research/2013-06-27-cdu73ivp7u6ir2ib1a8obcret6-regulation-update.html>.
33. For more details, see Mitchell, "Pathology of Privilege."

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