POLITICAL ECONOMY
IN THE CAROLINAS

THE POLITICAL ECONOMY OF CRAFT BEER IN NORTH CAROLINA (AND BEYOND)

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This paper pulls together several recent threads of policy analysis on the craft-beer industry, with specific reference to the ongoing political conflicts in North Carolina between brewers and distributors. Drawing upon previous research, we explore the political-economy questions pertinent to the discussion on how regulation impacts the craft-brewing industry. Specifically, we explore (1) how the three-tier system sets up wholesalers as monopoly enforcers of alcohol distribution, (2) how this arrangement has impacted the emergence of the craft-beer industry, (3) what arguments are used to justify the status quo, and (4) why, in short, rent seeking is not a necessary ingredient of craft brewing. We conclude by providing recommendations for policy makers looking to remove barriers to entry in this market.

KEYWORDS:
craft beer, three tier system, rent seeking, local entrepreneurship

I. INTRODUCTION

Craft brewing has emerged as the fastest-growing segment of the beer industry in the past three decades. In 1995, there were 977 breweries operating in the United States. By 2015, the number had increased to 4,269, accounting for 12.2 percent of overall beer sales. Despite some turbulence in the mid-1990s, in part due to distribution problems (see Tremblay et al. 2005, p. 130), craft beer has represented a leading growth sector of the overall alcohol market. Observing the exponential growth of craft brewing, Caroll and

Swaminathan (2000, p. 716) noted, “Considering that in 1983 only 43 brewing firms operated in the United States, the milestone reflects a remarkable period of industrial renewal.”

This growth has changed alcohol consumption patterns in many states and localities across the United States. Commenting on the change in consumer tastes that has accompanied this trend toward craft beer, Williams (2017, p. 2) explains, “American tastes in beer are changing. Consumers want increased choice in beer styles, moving away from American light lager which has dominated the market for generations.” By surveying craft-beer production in Charlotte, North Carolina, Williams illustrates this trend on a local level, reporting, “In 2015, Fortune Magazine described Charlotte as the ‘Newest Hub for Craft Beer’, arguing it holds the title of the South’s most important beer city” (p. 4). While Charlotte has over three dozen breweries, it is still just a part of the larger North Carolina craft-beer scene, which is a $1 billion industry with 190 breweries in production (Morrill 2017b)[1].

This decades-in-the-making disruption of the beer industry has been met with an accompanying entanglement with political interests (Wagner 2016), mostly in the form of regulation and taxation via the three-tier system (see, e.g., Koopman and Mitchell 2014). As we explain in greater detail below, the three-tier system separates beer suppliers and beer consumers with a middle, wholesaler tier responsible for alcohol distribution to varying capacities depending on state law. While this regulatory structure has its detractors (Verive n.d.), it is regularly and widely justified as both assisting small brewers gain market share and playing a vital role in consumer protection (Kent 2014). Enforcement of these laws is typically carried out at the wholesaler tier, which is also responsible for tax collection. Williams (2017, p. 1) notes that in 2015, “There were also more than 7000 beer [wholesaler] distributors across the nation; generating more than 48.5 billion in tax revenue.”

This political entanglement, with tax collection and regulatory control through the wholesaler tier, has become the accepted standard for alcohol distribution in the United States. The state of North Carolina is noted for its relatively modest regulatory interference in the brewing industry, at least for the region. It is one of few states, for example, that allow breweries to distribute their own beer on-site. By way of comparison, South Carolina does not allow self-distribution and “has 22 breweries and 14 brewpubs across the state. North Carolina has more than 120 breweries and brewpubs and allows brewers to self-distribute up to 25,000 barrels annually” (Kiss 2015). Proponents of the three-tier system claim this arrangement is responsible for its status as “best beer state south of the Mason Dixon line” (Kent 2014).

While it is true that North Carolina is one of the states more favorable to alcohol distribution in the South, regulatory hurdles at the wholesale level create barriers for entrepreneurs by increasing the cost of distribution with little evidence of consumer benefits. Malone and Chambers (2017), for example, find that each step of the alcohol supply chain is subject to more than twenty thousand regulations, with most of these affecting the brewer level directly (Malone and Chambers 2017). These laws—in particular, those mandating the three-tier distribution system—create vertical restraints that limit a brewer’s ability to distribute products directly to retailers and consumers. Furthermore, as Linnekin (2016, p. 31) documents, regulatory authorities often act without appreciating the craft

1. As Williams (2017, p. 3) explains, three breweries in particular responsible for the current boom in Charlotte are Olde Mecklenburg Brewery (OMB), NoDa Brewing Company (NoDa), and Birdsong Brewery.

that craft brewing entails (Linnekin 2016). Yet as Tamayo (2009 p. 2226) effectively summarizes, "The three-tier system is deeply embedded and appears to be accepted at all levels of the industry."

It was the original Adam Smith who noted, "People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices" (Smith 1776). While such collusion undertaken today would be a violation of antitrust laws, laws mandating a distribution system have the same effect: the three-tier system creates a protected class of wholesalers and established brewers who stand to benefit from these laws at the expense of both their competition and consumers. As Tamayo (2009, p. 2203) observes in the context of North Carolina beer law, "Independent of any nobler intent the wholesalers might have, there is some economic motive on the part of wholesalers to protect against brewers circumventing the wholesale tier."

Much of this profit goes to sustain the system via political entrepreneurship in the form of lobbyists and campaign finance. The National Beer Wholesalers Association, for instance, is the third-largest political action committee in the country, giving away more than $4 million in the 2016 election cycle alone (Center for Responsive Politics 2018; White 2011). North Carolina has its own set of political entrepreneurs acting on behalf of both wholesalers and brewers. The North Carolina Beer and Wine Wholesalers Association was founded in 1936 on behalf of beer and wine distributors in North Carolina. The group spent nearly $1.5 million on political influence in the last four years (Morrill 2017b).

Despite its widespread acceptance, it's not clear that the core restrictions of the three-tier system improve consumer welfare or achieve even the more modest goal of greater product variety. To better understand the political economy of craft brewing, we draw upon the regulatory landscape in North Carolina as a case study. We begin with a brief history and explanation of the three-tier system along with a discussion of the emergence of craft beer as an alternative to so-called macrobreweries such as AB InBev and SabMiller. We then turn to the primary justifications for the three-tier system, and explain why this system has remained in place so long. In particular, we evaluate the set of competing claims made about the three-tier system by building upon previous research on craft brewing, vertical restrictions, and mandated three-tier distribution systems. We explain how these restraints are unlikely to accomplish the stated goal of increasing distribution at the local level. We also examine the rent-seeking aspects of these laws in creating protected incumbents that continue to gain from the status quo arrangement at the expense of new entrants and competition. We conclude with recommendations for policy makers interested in ending regulatory barriers that thwart the greater growth potential of craft brewing in North Carolina and beyond.

II. THE HISTORY AND MARKET STRUCTURE OF THE THREE-TIER SYSTEM

While Prohibition ended nearly a century ago—later for North Carolina, where Prohibition was in effect until 1935[2] —it still defines the present institutional arrangements between different parts of the alcohol supply chain (see also Tamayo 2009). As Tamayo (2009, p. 2205) explains:

2. North Carolina voters rejected ratifying the Twenty-First Amendment in 1933. However, in 1935, the General Assembly began passing bills that would allow individual counties to vote on allowing liquor sales within their boundaries. See, e.g., Pasquotank Act 1935. For a fuller discussion of North Carolina's history with alcohol prohibition, see Steelman 2010.

> The source of the three-tier system is Section 2 of the Twenty-first Amendment, which states that '[t]he transportation or importation into any State, Territory, or possession of the United States for delivery or use therein of intoxicating liquors, in violation of the laws thereof, is hereby prohibited.' Courts have interpreted this section to grant states broad authority to regulate alcohol within their borders. With the repeal of the Eighteenth Amendment of the Constitution—ending Prohibition—in 1933, the power to regulate the production, distribution, and sale of alcohol was explicitly returned to the states[3].

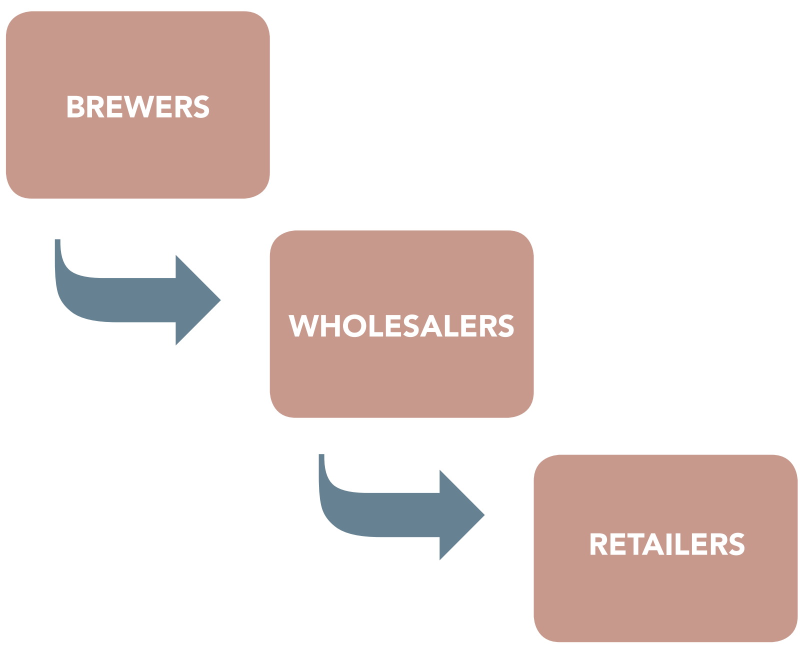
These regulatory restrictions emerged swiftly in the post-Prohibition era and have laid the foundation for state-level regulation on alcohol over the past eighty-four years.

These laws were put in place to prevent the so-called tied-house problem, which occurs when a supplier controls distribution of product to the consumer in a way that excludes other suppliers. As Gohmann (2016 p. 5) explains: "In the early 1900s, the national breweries were competing with local breweries. Since most beer was sold in kegs and served in saloons, the local breweries started their own saloons, and only their beer would be sold in these saloons. These were called tied houses."

Suppliers distributing to remote locations exercised exclusive control over distribution in these markets to cover their operating costs. That is, "large brewers, who had invested substantial capital in technology to allow them to reach distant markets, especially needed security due to their massive capital expenditures" (Tamayo 2009, p. 2207). In addition, the temperance movement led to higher licensing fees and regulatory barriers at the retail level. By increasing the costs of creating and maintaining a distribution network, gaining entry into the brewing market became difficult for all but the largest suppliers (Tamayo 2009, p. 2208).

Accordingly, these public policies were

Figure 1. The Three-Tier System of Alcohol Distribution



3. See U.S. Const. amend. XVIII, sec. 2. ("The transportation or importation into any State, Territory, or possession of the United States for delivery or use therein of intoxicating liquors, in violation of the laws thereof, is hereby prohibited.")

written with a specific focus on preventing direct interaction between those who manufacture alcohol and those who consume it. By inserting a middle tier, occupied by wholesaler distributors, the system was designed to ensure competition among alcohol suppliers. As Gohmann (2016, p. 5) explains, "The main law from the national breweries' perspective was the three-tier system, which required breweries to sell beers to distributors who would then sell to retailers. This eliminated the tied houses and resulted in the demise of many of the local breweries from the 1940s through the 1970s."

The three-tier system was adopted by nearly every state following the repeal of Prohibition[4]. In its simplest form, as the figure below shows, the three-tier system dictates that brewers (manufacturers) can only sell to wholesalers (distributors, shippers, etc.). Wholesalers can only sell to retailers (grocery stores, bars, restaurants, liquor stores). Retailers are then allowed to sell to consumers.

In an effort to keep greater distance between suppliers and consumers, many states have included additional restrictions on vertical integration. For example, in most states the law also dictates how brewers may interact with wholesalers, and on what terms a supplier may choose to work with a competing distributor.

Burgdorf (2016a, p. 1) provides a useful breakdown of the major restrictions on alcohol distribution generated by the three-tier system. These are (1) prohibitions on brewers acting as wholesalers (divestment); (2) beer franchise laws, which restrict when a brewer can end a contract with a wholesaler; and (3) mandated exclusive wholesale territories via contracts with brewers. These restrictions constrain beer production at the local level as they limit how parties may contract with one another.

North Carolina includes a number of contract restrictions, including (1) state-enforced exclusive territories for wholesalers. Further, (2) contracts can be terminated only upon showing good cause[5] and only after ninety days' written notice;[6] upon written notice, the wholesaler must be given forty-five days to resolve any issues. Tamayo (2010, p. 2205) notes, "North Carolina is among the thirty-four states allowing self-distribution, and permits brewers to also act as wholesalers if they manufacture fewer than 25,000 barrels per year" (Whitman 2003, p. 4) In addition, brewers are allowed a limited financial interest in wholesalers[7], a provision that is more inclusive than in many other states. North Carolina has in fact allowed some degree of retail sales by brewers since 1985:[8]

- 1985: Permitted retail sales at a brewery of up to two thousand barrels, with no self-distribution.
- 1991: Permitted retail sales of ten thousand barrels at a brewery. Still no self-distribution rights.
- 1993: Self-distribution, with on-site sales and distribution capped at a combined total of ten thousand barrels.
- 2003: Cap for on-site sales and self-distribution raised to twenty-five thousand barrels.

4. In fact, it was not until 1978 that President Carter amended the law such that individuals could even brew alcohol for private use (see Williams 2017, p. 2).
5. N.C. Gen. Stat. § 18B-1305)(a). ("Good cause for altering or terminating a franchise agreement, or failing to renew or causing a wholesaler to resign from such an agreement, exists when the wholesaler fails to comply with provisions of the agreement which are reasonable, material, not unconscionable, and which are not discriminatory when compared with the provisions imposed, by their terms or in the manner of enforcement, on other similarly situated wholesaler by the supplier. The meaning of good cause set out in this section may not be modified or superseded by provisions in a written franchise agreement prepared by a supplier if those provisions purport to define good cause in a manner different than specified in this section. In any dispute over alteration, termination, failure to renew or causing a wholesaler to resign from a franchise agreement, the burden is on the supplier to establish that good cause exists for the action.")
6. N.C. Gen. Stat. § 18B-1305)(b).
7. N.C. Gen. Stat. § 18B-1119.
8. As we discuss below, it is no coincidence that the first craft brewer in North Carolina opened in 1986 "when Uli Bennewitz, after lobbying the state law makers to make brewpubs legal, opened the Weeping Radish Brewpub in eastern North Carolina" (see Tamayo 2009, p. 2215).

Williams (2017, p. 3) explains how enforcement of these laws is carried out in practice: "The state set into place the Alcohol Boards of Control (ABC) structure, giving local jurisdictions control over the production, distribution and sale of alcohol across N.C. County ABC Boards are local independent political subdivisions of the State Boards, operating as separate entities, establishing their own policies and procedures. They retain authority to set policy and adopt rules in conformity with ABC laws and N.C. ABC commission rules."

Under the ABC system, North Carolina statutorily mandated exclusive territories for a limited number of licensed wholesalers[9]. The primary justification over the past thirty-five years has been twofold. First, it increases the ease of collecting taxes on the distribution and sale of beer. Second, this arrangement ensures that wholesalers secure returns on investment. The taxes generated by the three-tier system are primarily collected by wholesalers as administered by the ABC system. North Carolina has one of the highest excise-tax rates in the country at $19.13 per barrel. Wholesalers serve as tax collectors for state government and in this way provide a valuable public service. The latter justification calls to mind the dilemma that arose with tied houses. Suppose, for example, a wholesaler invested in advertisements and promotional material for a new local beer. If any other wholesaler could benefit from distributing the product without needing to share in the expenses of advertising, what incentive would the original wholesaler have to invest in building awareness of the new beer?

Exclusive territories are designed to reduce exposure and competition among wholesalers. By reducing competition, economic theory would suggest that the incentives facing a wholesaler become different in a way that can prove beneficial to the consumer. Klein and Murphy (1988, p. 273) provide the seminal argument for the use of exclusive territories:[10] "When the manufacturer cannot contractually specify the supply of desired services, and services are subject to free riding, each dealer can increase its short-run profit by shirking on the supply of services. Exclusive territories may appear to provide a solution to this problem."

In the context of beer distribution, this would imply that offering wholesalers exclusive territories in distributing local craft brands ensures that product quality is maintained. For example, utilizing a wholesaler for a specific geographical area creates an incentive for the wholesaler to invest resources in advertisement and distribution by ensuring that other wholesalers will not free-ride off of the original wholesaler's efforts.

Hence there are reasons why producers and wholesalers would voluntarily enter into contractual arrangements that include provisions such as exclusive territories. As Whitman explains, these agreements "can help mitigate some of the incentive problems that arise from the lack of vertical integration" by providing a means for wholesalers to internalize the benefits on improving product quality and awareness (Whitman 2003, p. 23). Furthermore, as Tamayo (2010, p. 2217) notes: "For many years, starting shortly after Repeal, the biggest brewers had significant power over wholesalers through the threat of termination, and they used this power to pressure smaller wholesalers into dropping competing brands. This trend continued well into the late twentieth-century, with large brewers offering financial incentives to get the loyalty and exclusivity of their distributors." Accordingly, wholesalers with a greater bargaining advantage could potentially benefit consumers by

9. N.C. Gen. Stat. § 18B-102.

10. We thank an anonymous reviewer for this reference and clarity on the distinction between exclusive territories and broader exclusive-dealing arrangements.

increasing the available choices.

Mandating exclusive territories through the three-tier system, however, presents a much different situation. In a survey of the empirical literature on laws that limit or constrain relationships, LaFontaine and Slade (2008) found "when restraints are mandated by the government, they systematically reduce consumer welfare or at least do not improve it" (Lafontaine and Slade 2008). Where these agreements make most sense, they will be entered into by brewers and wholesalers voluntarily. Involuntary arrangements, on the other hand, provide dubious benefits to both parties. Brewers locked into contracts with a specific wholesaler without nearby competitors can no longer incentivize product quality. Even wholesalers may find themselves in a "transitional-gains trap" in which future profits from attaining a geographic monopoly are capitalized into the cost of acquiring the wholesale license (see Tullock 1975).

Moreover, these restrictions give the wholesalers outsized influence over the market performance of any particular product by creating a situation in which the wholesaler can dictate terms of performance to brewers, who are left with little recourse. Steve Hindy, founder of Brooklyn Brewery, has provided a first-hand account of how this affects brewers' abilities to grow and distribute their beer (Hindy 2014):

> I once tried to terminate a contract with an underperforming distributor in New York for not only selling my products outside of his territory, but selling out-of-date beer. I thought it would be straightforward, since my contract said I could leave "with or without cause."
>
> But the distributor took us to court, saying the state's franchise law, which sets a high standard for showing cause, trumped whatever my contract said. Two State Supreme Court rulings upheld my position, but, fearing a further appeal, I settled out of court. I was freed from the contract, but the legal fees and settlement cost Brooklyn Brewery more than $300,000.
>
> Stories like this abound: My fellow craft brewers at Dogfish Head, in Delaware, faced a half-decade-long, six-figure legal dispute with a distributor just to terminate their contract.

This example of stifling of creative entrepreneurship illustrates how existing alcohol-regulation laws can come between brewers and retailers in a way that does not clearly benefit consumers.

In many respects, these laws may have outlasted their own intentions, as Tamayo (2010, p. 2213-14) explains:

> These laws were intended to protect what were then small, family-owned distributors against breweries that held significant market share and thus wielded significant bargaining power.… Today bargaining power is shifting, yet franchise laws remain in place without a change in explanation. The rationale for franchise protection laws was based on the premise that wholesalers were small and suppliers were large; however, the introduction of craft brewing in the late 1970s shook up the industry and has thrown the foundation for the franchise laws into question.

III. THE RISE OF CRAFT BEER AND REGULATION OF CONSUMER CHOICE

To be sure, the emergence of the craft-beer industry was never anticipated by those responsible for creating the three-tier system. Williams (2016, p. 8) provides context for why this market disruption is economically significant:

> The volume share for craft brewers in the U.S.A. in 2015 was 12.2%, rising more than

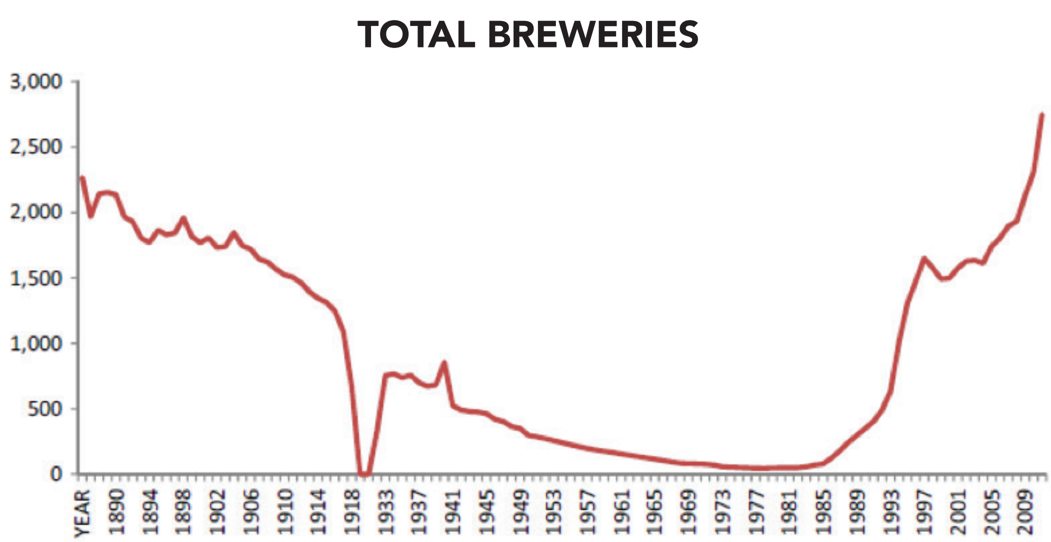
> 12.8% per annum. This demonstrates a stark contrast to an otherwise stagnant U.S. beer market, where craft beer represents the only domestic beer growth arena. The growth in the craft beer market has taken place against a backdrop of declining beer sales across the U.S.A., both in volume and dollar amounts.

American consumers are showing greater preference for wine and spirits, with a corresponding decline in beer consumption (*Economist 2017*). Nevertheless, craft beer has increased in market share in the alcohol industry even as more traditional brands face stagnant sales. This distinction in consumer tastes between macro- and microbrewing is worth exploring in greater detail.

Carroll and Swaminathan (2000, p. 718) find that “in the American beer industry the combined market share held by the four largest firms rises from under 10% in 1910 to over 80% in the 1990s.” As Tremblay et al. (2005, p. 317) explain, “New technologies that led to greater plant automation, increased speed of canning and bottling lines, and lower transportation costs gave large scale brewers a cost advantage.” The authors estimate “that the macro sector of the U.S. brewing industry was oligopolistic by about 1970” (p. 313). This is evident from the figure below (reprinted with permission from Gohmann 2016), which shows over a century of changes in the brewing market (reproduced from Gohmann 2016).

Most of the market is consolidated into three major brewers: Anheuser-Busch, Coors, and Miller. Elzinga et al. (2015, p. 244), for example, report that “ABI [Anheuser-Busch InBev] and MillerCoors combined had a share of the market (SOM) of beer sales in the United States of 73% in 2013.” The authors attribute this concentration to the fact that “brewers who produced large quantities of beer were able to take advantage of economies of scale. The scale and marketing advantages of the larger macros led to the ultimate demise of most of the smaller regional breweries of traditional lager beer.”[11]

Figure 2. Decline and Rise of Breweries in the United States



Data Source: Beer Institute (2013).

11. Tremblay et al. (2005, p. 318) estimated the minimum efficient scale of macro beer production at “over 23 million barrels by 2001.”

Despite this trend to greater market concentration, as Tremblay et al. (2005, p. 320) explain in detail, "the exit of most regional mass-producers created local niche markets that were soon served by specialty brewers. These local specialty brewers offered high-priced, craft-brewed beer to appeal to more affluent consumers who wanted something different from the nearly homogeneous American lager produced by the remaining macro brewers."

According to Tamayo (2010, p. 2215), "Craft brewing arose out of a developing niche of beer drinkers in the 1960s who wanted more beer variety and fuller flavor in comparison to the largely uniform offerings from the major domestic brewers." For a country built upon a German-inspired taste for light lager, expanding these drinking horizons was no small feat. It required the work of what would ultimately become thousands of brewers creating new tastes through experimentation and local entrepreneurship. Caroll and Swaminathan (2000, p. 716) summarized this movement as follows: "Nearly every one of the breweries founded in the last 20 years is associated in some way with the self-labeled 'microbrewery' movement, a group of brewers and consumers concerned with craftsmanship and taste in brewing beer. Collectively, these breweries have introduced and reintroduced to the American market a wide variety of new malt beverage products. Individually, the breweries tend to be small and specialized in their product offerings and target markets." The microbrewery movement shares a passion for craft, and as Tremblay et al. (2005, p. 308) explain, "all brewers with micro-brewery origins have come to be called specialty or craft brewers."

This emphasis on craft and local flavors impacts everything from production to marketing to distribution. For the most part, craft brewing is about self-distribution and independence from larger companies and organizations as a means of differentiating a craft brewer from macrobreweries. Elzinga et al. (2015, p. 242) write, "In contrast to the more commodity-like lager beer produced by the macrobrewers in the United States, the output of the craft segment more closely resembles the product differentiation and fragmentation in the wine industry."

Not all craft brewers self-distribute. Tamayo (2010, p. 2233) explains, "While some chafe at allowing distributors to receive some of the benefits of that value, others find the benefits of using a distributor—a lack of cost difference and, more importantly the ability to focus on brewing free from distraction—to be worthwhile enough to enter into a distributorship agreement." In addition, many large breweries have acquired craft breweries to maintain their market share through the "contract" brewing method (Kell 2016). This is when brewers allow another company to assist directly in production. In reporting on examples of contract brewing, the *Wall Street Journal* noted (Maloney 2017):

> Shipments are still rising for many of those craft brewers that sold themselves to industry heavyweights, including Lagunitas, which was bought by Heineken in May; Goose Island, owned by AB InBev since 2011; and Ballast Point, which was purchased by Constellation Brands Inc. for $1 billion in 2015. Those brands benefit from their parent companies' distribution networks, capital and marketing.

Contract brewing involves more than simple profit sharing, however, as production is often carried out by the acquiring company. As Tremblay et al. (2005, p. 310) explain, "Brewers such as Pabst are called 'contract' or 'virtual' brewers, since they are entirely marketing entities that do not produce their own beer." Put another way, generating greater distribution in beer markets can impact production in a way that undermines the sensibilities of craft brewers. This has created resentment toward those craft brewers who choose to partner with macrobrewers (Barbash and Andrews 2017). This matter of distribution continues to drive political conflicts in the alcohol sector, which we illustrate by examining the state of North Carolina.

IV. REGULATORY CONTROL OF BEER DISTRIBUTION IN NORTH CAROLINA

Craft brewing has disrupted the beer market in North Carolina by providing greater variety to consumers while challenging the distribution channels of the three-tier system, which favor larger brewers. Tamayo (2010) references this issue in describing how craft-beer production started in the state. He writes:

> In North Carolina, the first craft brewery entered the market in 1986, when Uli Bennewitz, after lobbying the state law makers to make brewpubs legal, opened the Weeping Radish Brewpub in eastern North Carolina.… Many of these early craft breweries were initially unable to tap into the distribution networks owned by larger brewers, and these breweries, like Weeping Radish and Red Oak, chose to start as brewpubs where they could both sell their beer on the premises and reap the markups that would otherwise go to retailers and distributors. (p. 2216)

Tension over distribution also played a significant role in the now-thriving Charlotte beer market. Williams (2017, p. 3) provides context for the Charlotte beer scene and its largest brewer, Olde Mecklenburg Brewer (OMB), explaining, "OMB paved the way for a second wave of craft brewing in Charlotte; quickly growing to be the largest of the Charlotte breweries." This growth inevitably brushed up against the restrictions of the three-tier system, however, and resulted in OMB removing its operations in the Research Triangle region to avoid going over the twenty-five-thousand-barrel cap, which would have forced it to work with a wholesaler to continue distributing above that limit (Thomas 2016). The brewery cited control of brand quality as the primary reason for this decision because under franchise laws it would have been forced to cede distribution of its products and have limited ability to maintain quality control if services were found wanting (ibid.).

To combat this political arrangement between wholesalers and North Carolina lawmakers, the owners of the two largest craft breweries in the state, Olde Mecklenburg Brewery and nearby NoDa Brewing Co., helped found a lobbying organization of their own called Craft Freedom (Thomas 2018). This group was created to raise awareness of the barrel cap in North Carolina through campaign-style tactics aimed at the county level, utilizing "strategists, pollsters, grassroots organizers and even campaign buttons" (Morrill 2016). This approach differs from the more traditional lobbying strategies employed by wholesalers, which apply political pressure to legislators directly.

A proposed legislative initiative in 2017 would have increased distribution to two hundred thousand barrels a year (Morrill 2016). Proponents cited the previous "Pop the Cap" legislation in 2005, which allowed brewers to produce above the previous alcohol-by-volume limit set at 6.0 percent and has since been cited as a key turning point for craft-beer production in the state. Other states have experienced similar growth in craft-beer sales as self-distribution has expanded (Duncan 2015). Nevertheless, wholesalers were able to block attempts to increase barrel limits after the Alcohol Beverage Control Committee amended the overarching bill (Dieterle 2017; Thomas 2017b;

Trump 2017).

In response, the owners of both NoDa Brewing Co. and Olde Mecklenburg Brewery filed a lawsuit claiming that the system is stifling competition and therefore unconstitutional (Thomas 2017a). The owners cite, for example, a "franchise agreement between Anheuser-Busch LLC and R. A. Jeffreys, a Raleigh-based wholesale distributor … [that] requires Jeffreys to give Anheuser-Busch 'priority over all other products'" (Morrill 2017c) as evidence of the obstacles the three-tier system places before small brewers attempting to gain market presence, "thereby harming consumers by artificially inflating prices and reducing consumer choice" (Morrill 2017a).

While the lawsuit continues to move forward despite recent efforts to dismiss it (Thomas 2018), it remains to be seen whether these legislative efforts or judicial challenges will change the three-tier system in North Carolina. They have certainly succeeded in bringing greater awareness to the matter and to the arguments made by proponents of the system to which we now turn. The prevailing narrative on craft-beer distribution and the arguments used in favor of the status quo are succinctly made in promotional media produced by the National Beer Wholesalers Association (NBWABeer 2014). We offer them as the arguments most favorable to controlling alcohol distribution at the state and local levels. We follow them with our own analysis.

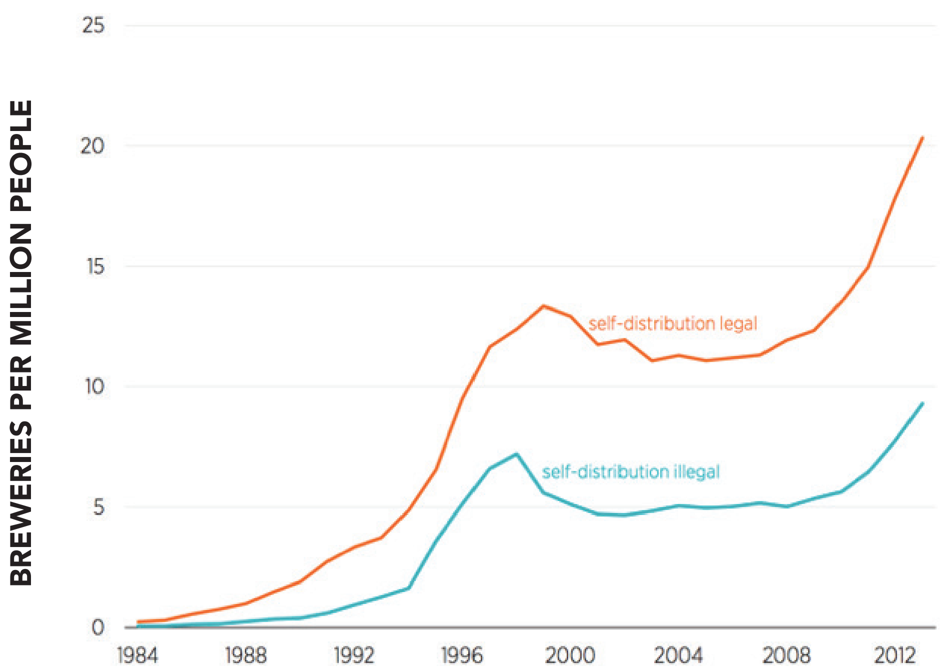
Proposition 1: The wholesaler acts as an independent distributor, thereby limiting market access for larger brewers in a way that allows for greater brand variety to the consumer.

In an op-ed response to another letter in the Charlotte Observer, the executive director of the North Carolina Beer & Wine Wholesalers Association explicitly made the following claim: "Thanks to the three-tier system which includes independent wholesalers, U.S. consumers enjoy great choice and an abundance of selection. The existence of a strong, independent middle tier has helped facilitate the explosion of craft distilleries, wineries and breweries." This argument is also referenced by Tamayo (2010, p. 2227), who notes that "many are for the three-tier system as they believe the independence of a middle tier allows for craft brewers to enter distribution channels." Because distributors play a vital role in promoting brand variety, it is argued that independent distribution is requisite for a competitive market. Wholesalers have labeled efforts by those who would disrupt this model as motivated solely to "squeeze out competition" (Kent 2017).

Regardless, the proposition that wholesaler control of the supply chain increases variety for consumers is dubious for two reasons. First, the vast regulatory environment created by the three-tier system in and of itself encourages consolidation of the beer market. Regulatory compliance is a significant cost factor in producing and distributing alcohol. State laws are inconsistent to the point that it's "almost like selling in fifty different countries" (Morrison 2013). Larger firms benefit from being able to spread this cost of compliance across a greater revenue, output, and employee base (Crain and Crain 2010). Three-tier regulations would therefore prima facie seem to favor larger brewers over smaller brewers less capable of absorbing these costs.

Second, and more importantly, the three-tier system provides wholesalers with enormous bargaining power by being able to (1) control distribution of the product over a large territorial domain, (2) help structure contracts so that they specifically favor wholesalers, and (3) influence state governments directly through their role as part of the larger fiscal apparatus. Taken together, these factors manifest significant influence on the growth of craft-beer production. Burgdorf (2016a, p. 14) finds that "states that did not restrict breweries from acting as wholesalers across the entire sample time from 1984-2013 have had 6.80 to 8.832 more breweries per million [state residents] than other states." Figure 3 demonstrates the difference in growth trajectories between states that allow self-distribution and those that do not.

Figure 3. Breweries per million people in states with and without self-distribution



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

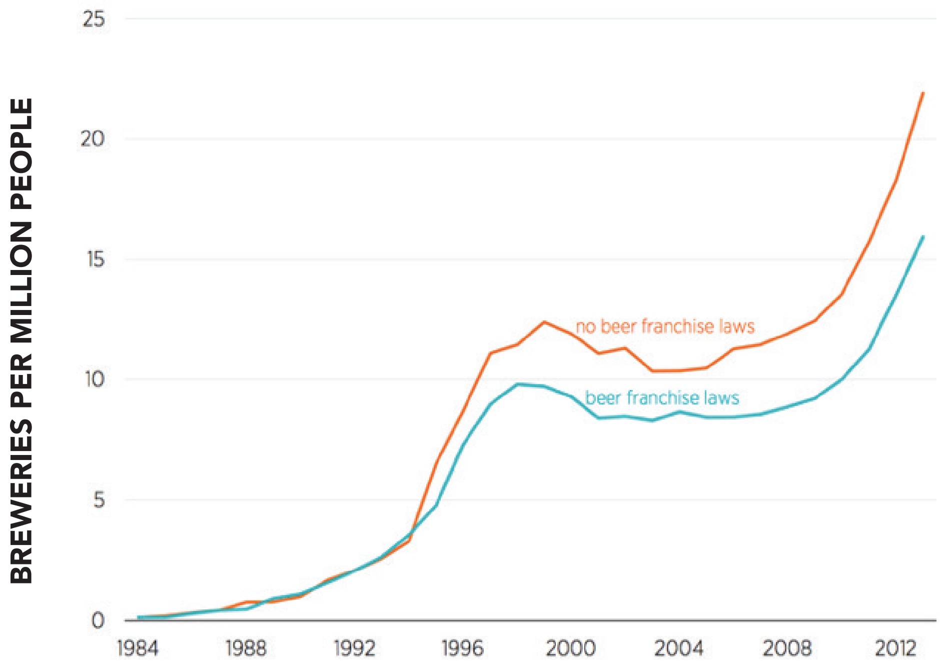
He further finds that states without beer-franchise laws averaged 21.91 breweries per million people, far more than the 15.94 breweries per million people in states with franchise laws.

Burgdorf finds overall that restrictions on self-distribution reduce the number of breweries by half in a state-by-state comparison; franchise laws reduce the number of breweries by about a quarter (Burgdorf 2016b). Despite what wholesalers claim, the greater the presence of the three-tier system and corresponding franchise laws within a particular state, the less variety there is as measured by number of in-state and local breweries.

Proposition 2: Independent distributors typically act within and are an important part of the local economy.

Distributors have a regional focus in their mandate. As we noted above, geographic monopolies granted by states typically offer distributors semi-autonomous control over certain territories that allow for the adequate scale and the accompanying return on investment needed to maintain the three-tier system. Though this creates a number of jobs at the wholesaler level, the

Figure 4. Breweries per million people in states with and without beer franchise laws.



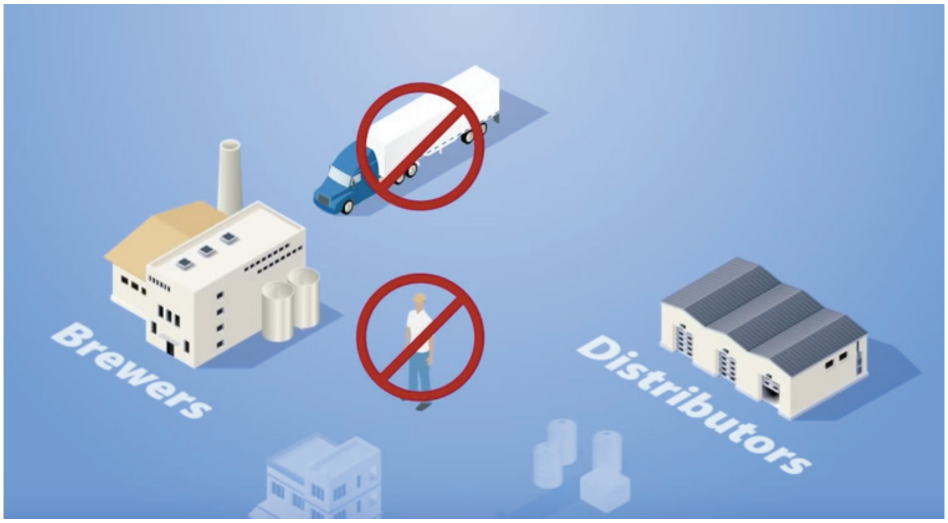
Source: Alcohol and Tobacco Tax and Trade Bureau and author's research of the legal histories of each state.

benefits to the local economy should be measured ultimately by their value added to the production process. Job creation taken alone is an arbitrary measure of economic impact that at best proxies the real value of labor to the local economy (see Roy Cordato's note in this issue).

Jobs that are of greatest benefit to the local economy are those that provide the most valuable service to the consumer at lowest cost. If jobs are being created through government decision, it is unclear whether this labor could be put to better use elsewhere in the local economy. To illustrate this point, consider the screenshot below, taken from a promotional video provided by the North Carolina Wholesalers Association. The graphic is meant to show how mandating distribution at the wholesaler level helps brewers by eliminating the need to perform these job roles themselves. The creation of jobs for wholesalers is then presented as a good thing for the local economy.

Ultimately, the determining factor for value added to the local economy should be in how the jobs add value to the production process. The three-tier system does not create jobs, per se, but simply ensures that these jobs will be performed by wholesalers rather than local breweries. Instead of labeling these jobs as a net addition to a local economy, they are best understood as a transfer of resources to wholesalers that would have gone to workers employed directly by brewers. In other words, mandating and creating jobs at one tier within the distribution network is coming at the opportunity cost of productivity and jobs at another tier.

Moreover, the research by Burgdorf cited above shows that self-distribution restrictions not



Source: National Beer Wholesalers Association. "NBWA/WBAE Three-Tier System Education Video." YouTube, YouTube, 27 Sept. 2014, www.youtube.com/watch?v=tqaFin7FhUo.

only lead to a significant reduction in the entry rate of breweries, but also have a negative effect on the production rates of craft brewers; he finds that production volume by craft brewers is 152 to 182 percent higher in states with no distribution restrictions (Burgdorf 2016b, p. 2). In this way, the three-tier system limits the growth potential of craft brewers by reducing the volume at which they can scale their enterprise. The ultimate result is a less productive, smaller industry at the local level with this production carried out on a massive scale by a small number of national firms.

> *Proposition 3: Resistance to the three-tier system by craft brewers reflects their own attempts to monopolize distribution at local retail outlets.*

In an op-ed targeted at the Asheville area, the executive director of the North Carolina Beer & Wine Wholesalers Association disputed the motivations behind craft-brewer efforts, claiming it was "to award themselves a special privilege that would put all other breweries and distributors at a disadvantage in a highly-competitive marketplace. With all this competition, it's no wonder two of the original Charlotte brewers now want to change the rules that helped make them successful in order to stack the deck in their favor." The underlying idea behind this argument is that these breweries would "squeeze out competition" at local retail outlets by self-distributing at greater scale than smaller brewers could afford (Kent 2017).

This argument is consistent with the idea that distributors play an indispensable role in driving product variety. But as we explained above, local breweries are most successful when they are able to compete with macrobreweries at point of sale. As Gohmann (2016, p. 3) explains, craft breweries "compete for shelf space that beer distributors want for their larger national accounts. If distributors and national breweries are able to limit the number of breweries in a state, it will lead to less competition and greater profits." In other words, the competitive pressures macrobrewers exert through three-tier distributional channels are most responsible for this perception of scarcity at the retail level.

Moreover, if vertically integrated brewers meant the monopolization of distribution and harm to the overall beer market, we would expect to find monopolized markets—that is, greater concentration at the retail level—where self-distribution is allowed. In other words, greater ability to self-distribute should increase market power according to arguments provided by wholesalers.[12] However, as we noted above, states in which self-distribution is allowed have both more brewers and more-productive brewers. Tremblay et al. (2005, p. 322) note, "Even when regional concentration is high, however, competition remains stiff since entry barriers are low, the macro brewers remain potential competitors, and import brands are close substitutes."

Furthermore, while tap space is constrained in a practical sense, there are no state laws mandating the number of taps a retailer can utilize. Retailers are therefore free to increase the number of taps available to keep pace with the variety of beers they wish to provide on an ongoing basis. Many drinking establishments have profited from (and helped sustain) the increase in craft-beer sales by providing larger numbers of taps. Even traditional bars have installed more taps. Far from the dire situation painted by proponents of the three-tier system, greater self-distribution does not appear to drive out competition at the retail level and may in fact increase product variety by allowing more brewers to compete at point of sale.

National beer producers and wholesalers, on the other hand, have a common economic interest in limiting retail distribution. By limiting the number of taps, for example, greater market power is created for larger companies like Anheuser-Busch InBev. Driving out competitors at point of sale brings hefty returns. Distributors benefit as well in that they are now providing a more valued service to larger beer accounts and in turn driving the market conditions necessary to maintain the three-tier system.

Proposition 4: Deregulation ultimately creates behaviors in opposition to the public interest.

A final claim that in some ways could outweigh the others combined concerns the matter of public interest. As Tamayo (2010, p. 2219) observes, "The new temperance movement is based on public health advocacy rather than morality, and it seeks to identify and reduce the economic costs associated with alcohol consumption." Cook (2007), for example, associates alcohol consumption with lost productivity, disability, early death, crime, family neglect, and personality deterioration, among other effects. Cesur and Kelly (2014) use these factors to demonstrate a negative correlation between alcohol consumption and economic growth. Perhaps it is necessary to have government-mandated independent distribution to facilitate orderly consumption of alcohol. For example, Chaloupka, Grossman, and Saffer (2002, p. 29) find "increases in the full price of alcohol—whether they result from increases in monetary price, reduced availability, or increases in the expected legal costs of drinking and driving (i.e., more severe drunk-driving laws)—can reduce drinking and driving and its consequences among all age groups."

Even if alcohol consumption has harmful effects, however, it is unclear that the core restrictions of the three-tier system (e.g., state-enforced franchise agreements, limits on self-distribution) are responsible for improving public-health outcomes. According to Ruhm et al. (2011), higher tax rates have a negligible effect on beer

12. Cooper et al. (2005, p. 631) comment more technically on the quality of arguments used against vertical integration: "The theory shows that vertical practices potentially can harm competition. This finding is fragile, however, as anticompetitive equilibria emerge only under specific—and difficult to verify—assumptions about (among other things) costs, demand, the nature of input contracts, conditions of entry, the slope of reaction functions, and the information available to firms." In other words, to advocate 'divestment' as a means of encouraging competition is circumspect without significant empirical evidence of monopolization of beer markets under self-distribution.

consumption. Furthermore, Malone and Lusk (2016, p. 325) find no relationship between state excise taxes and number of breweries of any kind, micro or macro. Moreover, as Gohmann (2016, p. 2) notes, "The nine states with the fewest breweries per population are all in the South. Yet in terms of beer consumption per capita, two of these states—South Carolina and Louisiana are in the top 13." This could reflect the fact that alcohol consumption has changed dramatically since the creation of the three-tier system. As Tamayo (2009, p. 2212) explains, "Although bars have replaced saloons, much more alcohol is sold off-premises today than was sold off-premises during the pre-Prohibition era." If alcohol consumption is taking place more frequently off-premises, then regulation at point of sale becomes less effective at curtailing drunken behavior.[13]

These laws also add to an intensifying problem that may be counterproductive to an effective, functioning market: regulatory accumulation (Koopman and Mitchell 2014). While many of these regulations are not insurmountable on their own, when taken together they represent formidable barriers to new brewers. Figure 5, which depicts the barriers to creating a craft brewery in North Carolina, puts into perspective the argument that the state is best in the region at regulatory interference.

V. EXPANDING OPPORTUNITY AND COMPETITION IN CRAFT BREWING

Mandating the three-tier system was done in the name of achieving a number of laudable public policy goals; however, as we outlined above, this system has become captured by the special interest groups that most benefit from these arrangements (Guze 2016)—namely, distributors, large brewers, and state governments. As Whitman notes: "The adoption of the policies that simultaneously concentrate market power, impede quality improvements, and impair efficient distribution can be justified only on the grounds of political expediency rather than on a careful consideration of the merits" (Whitman 2003, p. 40).

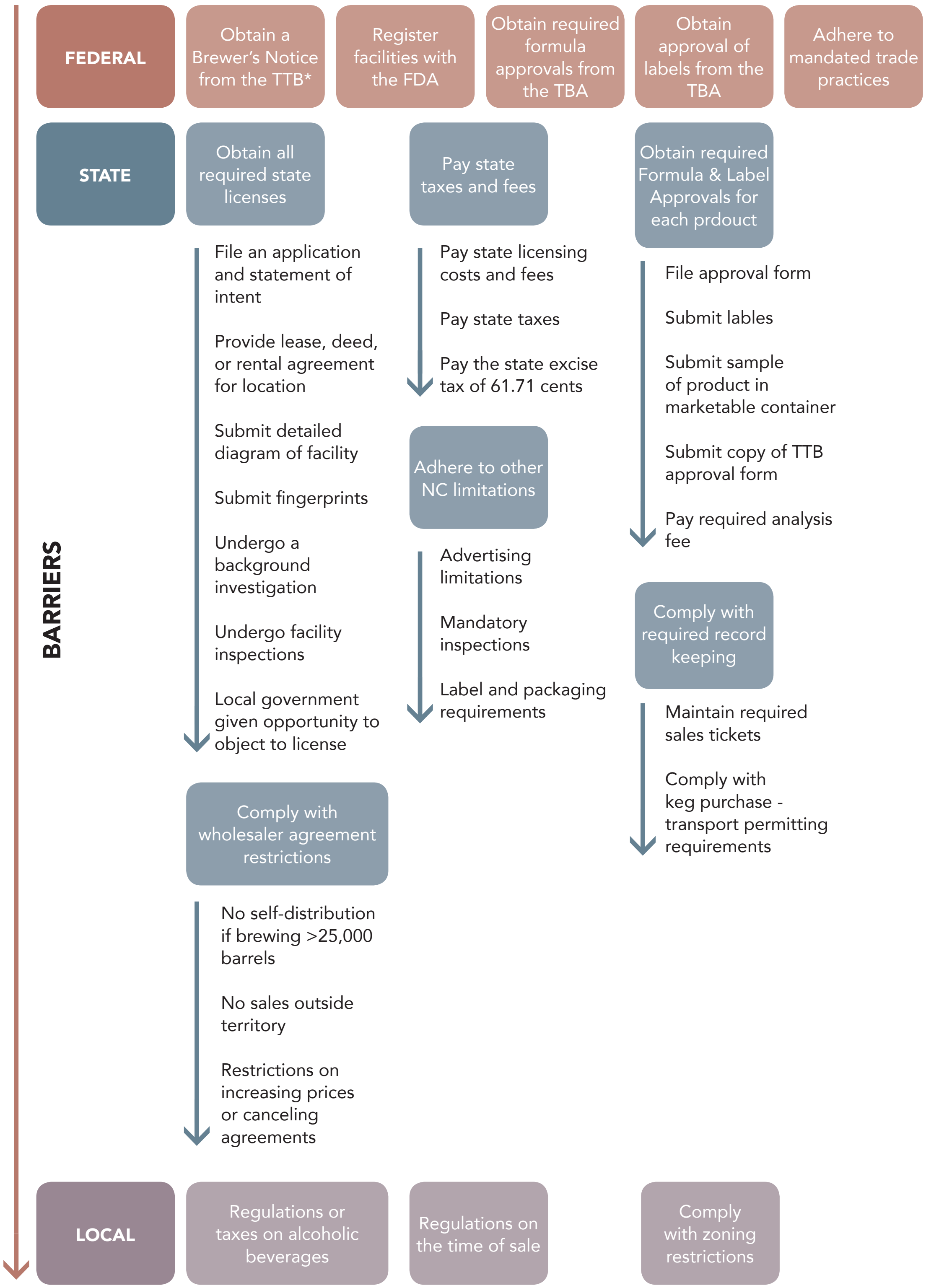
To summarize our argument, any attempt to monopolize distribution, be it at the supplier, wholesaler, or retail level, will generate rent-seeking activity and should be avoided. But rent seeking need not be a primary ingredient of the brewing industry. Without completely discarding regulation in brewing altogether, policy makers can improve the regulatory climate by avoiding constraints that have led to unintended, counterproductive consequences. The evidence presented above would indicate that limitations on self-distribution stifle opportunities for new-business growth and for development at the local level.

Accordingly, the three-tier system needs to adjust to developments in the brewing market, instead of being maintained in a way that creates obstacles to entrepreneurship without clear corresponding public benefits of equal magnitude. As Tamayo (2009, p. 2218) imparts, "Legislators should give themselves some latitude in adjusting the laws to track the changing conditions in the alcohol beverage industry." For policy makers in North Carolina, who have "explicitly professed an interest in promoting the growth of the craft brew industry" (Tamayo 2009, p. 2200), the continued growth of the brewing market across the country, along with the role local breweries are having in that growth, should provide strong incentive for getting these arrangements right; brewers have shown a willingness to move and grow their businesses in more hospitable regulatory climates[14]. North Carolina can either become a home for the future of this industry or watch craft brewers move beyond the Carolinas.

13. This also calls into question comparisons to UK beer markets where 85% of consumption takes place on-premises (see Slade 1998).

14. One of the more interesting findings from the empirical literature is that the location of craft brewing is associated with higher income (see Elzinga et al. 2015, p. 263).

Figure 5. Barriers to Starting a Craft Brewery in North Carolina



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