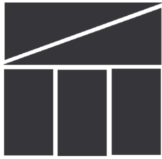

Economic Impact Analysis
Virginia Department of Planning and Budget

3 VAC 5-30 – Tied-House Regulations

Department of Alcoholic Beverage Control

March 8, 2004

The Department of Planning and Budget (DPB) has analyzed the economic impact of this proposed regulation in accordance with Section 2.2-4007.G of the Administrative Process Act and Executive Order Number 21 (02). Section 2.2-4007.G requires that such economic impact analyses include, but need not be limited to, the projected number of businesses or other entities to whom the regulation would apply, the identity of any localities and types of businesses or other entities particularly affected, the projected number of persons and employment positions to be affected, the projected costs to affected businesses or entities to implement or comply with the regulation, and the impact on the use and value of private property. The analysis presented below represents DPB's best estimate of these economic impacts.

Summary of the Proposed Regulation

§4.1-111 of the Code of Virginia authorizes the Alcoholic Beverage Control Board to promulgate regulations deemed necessary to carry out the provisions of Title 4.1 (Alcoholic Beverages and Industrial Alcohol). Specifically, the Code of Virginia requires that the Alcoholic Beverage Control Board promulgate regulations that maintain a reasonable separation of retailer interests from those of the manufacturers, bottlers, brokers, importers and wholesalers, prevent undue competitive domination of any person by any other person engaged in the manufacture, distribution and sale of alcoholic beverages in the Commonwealth, and promote reasonable accommodation of arm's length business transactions.

The proposed regulation (1) eliminates the restriction on merchandising activities by alcoholic beverage wholesalers on Sundays, except in localities that have ordinances restricting the sale of alcoholic beverages on Sundays, (2) allows wine and beer removed from the shelf for quality control purposes to be replaced with an identical quantity and brand but not necessarily

with identical packaging, (3) permits the use of a single invoice for sales of alcoholic and non-alcoholic beverage merchandise to retailers as long as the items are separately identified and totaled, (4) removes the provision requiring that retailers pay wholesalers a minimum deposit per container sold by the wholesaler to the retailer, (5) raises the maximum wholesale value of bottle or can openers on which advertising matter regarding alcoholic beverages appears that manufacturers, bottlers, or wholesalers can give retailers, (6) eliminates the restriction on the number of wines and beers that can be listed on clip-ons and table tents provided by manufacturers, wholesalers, or bottlers to retailers, and (7) eliminates the provision prohibiting manufacturers and wholesalers from providing retailers with business entertainment requiring overnight stays and instead increases the maximum amount spent on business entertainment in a 24-hour period from $200 to $400.

Estimated Economic Impact

Background:

Tied-house rules were adopted at the federal and state level following Prohibition in an attempt to prevent the intemperate consumption of alcohol. The name derives from a practice in England, where a bar or pub may be tied through ownership links or contractual obligations to a specific manufacturer of alcoholic beverages. Tied houses were allowed in the United States prior to Prohibition. However, it was thought to result in marketing practices that encouraged the consumption of alcohol.

Following Prohibition, tied-house rules were put in place to prevent the vertical integration of ownership of bars and alcohol manufacturers, which was seen to be encouraging alcohol consumption. Tied-house rules establish a three-tier marketing structure consisting of suppliers/manufacturers, wholesalers, and retailers and are designed to maintain the independence of each tier. The rules accomplish this by restricting ownership interests between tiers, by prohibiting the giving of “things of value” to retailers by suppliers and wholesalers, and by requiring that suppliers do not sell alcohol directly to retailers, but instead sell to wholesalers who then sell to retailers. In Virginia, the exceptions to the rule include farm wineries (which are allowed to sell their product to consumers and retailers directly) and direct shipment of alcohol to consumers by licensed in-state and out-of-state wineries, farm wineries, breweries, and alcoholic beverage retailers.

Tied-house regulations exist at the federal and state level in the United States. According to the Department of Alcoholic Beverage Control (ABC), Virginia's tied-house regulations are more restrictive than federal regulations. Rather than prohibiting certain things from being given to retailers by manufacturers and wholesalers as in Virginia, federal regulations generally set a dollar limit on the amount of the gift. For example, Virginia's tied-house regulations prohibit manufacturers and wholesalers from selling or giving product displays (such as wine racks, bins, shelving, etc.) to retailers. Federal regulations prohibit giving such display only if they exceed $300 in value.

According to ABC, all states have some type of tied-house regulations. How restrictive these regulations are vary from state to state, with some states having more restrictive regulations than Virginia and others having less restrictive regulations. Some states, such as West Virginia, have adopted federal tied-house regulations rather than establish their own tied-house rules.

Relevance:

While tied-house regulations may have had some relevance in the post-Prohibition era, their relevance in current times is unclear. Tied-house regulations were established to prevent the establishment of monopolies and deal with specific issues relating to alcohol consumption arising out of the vertical integration of retailers and manufacturers in the 1930s. These issues are no longer as relevant today.

In the pre-Prohibition days, manufacturers of wine and beer tended to serve a small geographic area and frequently owned or had influence over retail outlets in the area. This was because they tended to be larger and have more capital than the retail establishments. However, that situation no longer exists. Beer and wine is now sold not only at bars and taverns, but also at grocery stores, drug stores, and convenience stores[1]. According to ABC, there were approximately 12,930 retail licensees operating in Virginia in 2003. Due to the large number of retail outlets selling wine and beer, vertical integration and manufacturer control over retail outlets is no longer as simple or easy. Moreover, many retail outlets now include grocery stores, convenience stores, and drug stores, many of which are run by large corporations that are not likely to be easily influenced or controlled by wine and beer manufacturers. These

[1] Of the 12,930 retail licensees in 2003, a little over 50% were grocery stores, convenience stores, gourmet shops, drug stores, and delicatessens.

establishments sell many products other than alcohol and compete with each other for market share in the sale of all these products, not just alcohol. Incentives and promotions offered by beer and wine manufacturers to stock only their brand are not likely to outweigh the potential costs to these retailers (in terms of a loss of business) of limiting the choice and range of alcoholic beverages provided by them to their customers.

Apart from a change in the number and type of retail outlets selling wine and beer, there has also been a change in the way wine and beer manufacturers operate. Unlike the pre-Prohibition era, manufacturers can no longer count on having monopoly power in any geographic area or market. There are now many more manufacturers competing for market share, including local, national, and international manufacturers. Thus, the choice and range of available beer and wine is not limited by the monopoly power of any single manufacturer as it was in the early 1900s. The presence of a number of manufacturers in any given market reduces the likelihood of any one manufacturer exerting undue influence and power.

Changes in the industry aside, there have also been changes in drinking habits. U.S. per capita consumption of pure alcohol between 1991 and 2000 was only slightly lower than per capita consumption in the decade preceding Prohibition. However, public drunkenness is nowhere as extensive as during the early 1900s, when most consumption was on-premise and concentrated heavily toward payday binges. Thus, any increase in alcohol consumption is not likely to produce the magnitude of social and economic costs it did in the pre-Prohibition era. Moreover, U.S. adult per capita pure alcohol consumption has been declining since the early 1980s, a fact that appears to be independent of tied-house restrictions (which were introduced in the mid-1930s). Factors such as price, income, region, education, and household demographics have been found to be significant determinants of household alcohol expenditures. In addition, research has shown that an aging population, regulatory changes (such as a tightening of the drunk-driving laws), and a trend toward more healthy lifestyle (reflected in a shift toward drinks with reduced alcohol content such as wine coolers and light beers) could also be responsible for some of the decline in per capita pure alcohol consumption since the 1980s.

Thus, changes in the way the industry operates, both in terms of retailers and manufacturers, and changes in U.S. alcohol consumption habits make it unlikely that a situation

reminiscent of the pre-Prohibition era will come to pass in Virginia if the tied-house restrictions were removed.

Implications of Removing the Tied-House Restrictions:

Removing the tied-house restrictions is likely to increase economic efficiency and produce significant economic benefits. Rather than making choices regarding the supply and sale of alcohol based on what is allowed under the tied-house rules, manufacturers and retailers will be able to make choices and pursue strategies that maximize profits under various market conditions. Decisions made in this manner are likely to reduce waste of resources and produce a more efficient allocation of resources. For example, dismantling the three-tier system will allow manufacturers to sell their product directly to retailers, without having to go through wholesalers. By removing the middleman, wine and beer will be provided at lower cost to retailers and hence to consumers. Moreover, restriction placed by the tied-house rules on the how manufacturers promote and sell their alcohol serve to limit competition between manufacturers and are yet another factor in keeping alcohol prices higher than they would be otherwise. Finally, by allowing all manufacturers, not just local farm wineries, to sell directly to retailers, removal of the tied-house regulations will encourage competition from in-state and out-of-state wine manufacturers, increasing the choice of wines available to consumers and lowering the price of alcoholic beverages in Virginia even further. Manufacturers who might otherwise have been priced out of the market by local farm wineries due to the requirement of having to go through a wholesaler may now be more inclined to sell their product in Virginia.

Providing alcohol at lower cost is likely to impose some economic costs on the state in terms of increasing alcohol consumption. It should be noted that a wide variety of factors, not just own-price, affect the consumption of alcohol. However, to the extent that price does have an impact on consumption, a reduction in the price of alcohol could result in an increase in consumption. Increased alcohol consumption imposes social and economic costs through rising health costs, falling productivity, and an increase in social problems such as domestic abuse. A 1998 study by the National Institutes of Health estimated that alcohol abuse and alcoholism generated costs of about $148 million (or approximately $580 per capita) in 1992.

Existing studies indicate that the sensitivity or elasticity of demand to the price of wine or beer is not very large. Elasticity of demand for beer tends to be inelastic, with estimates ranging

from -0.25 to +0.24 (i.e., a 10% reduction in the price of beer is likely to result in an increase in consumption of less than 10%). Elasticity estimates for wine range from –0.64 to –1.00 (i.e., a 10% reduction in the price of wine is likely to result in a 10% or less increase in demand), indicating that wine demand also tends to be inelastic, albeit less so than beer demand. In order to accurately evaluate the costs of increased alcohol consumption, it is essential to study the impact of a decrease in price on alcohol consumption by heavy drinkers and individuals susceptible to alcoholism. A study by Manning et al. (1995) [2] finds that the elasticity or sensitivity of heavy drinkers to change in the price of alcohol tends to be low. The study finds that at the 95th percentile for drinkers, the elasticity estimate is not significantly different from zero. The impact of a decrease in price of alcohol on consumption by individuals susceptible to alcoholism is not known.

Thus, while a decrease in price of wine and beer is not likely to result in a very large increase in consumption, it is likely to result in some increase. This increase in consumption is likely to result in increased revenues collected by the state through excise and other taxes on alcoholic beverages. The additional revenues collected could be used to defray some of the additional costs associated with increased alcohol consumption.

If the cost to the state of a modest increase in consumption of wine and beer were determined to be too high, then a combination of simultaneously removing the tied-house restrictions and raising excise tax such that the retail price of alcohol remains unchanged would result in a more efficient allocation of resources than currently exists. The waste of resources occurring under the tied-house regulations will be captured by the state in terms of increased excise revenues. These resources are currently being wasted through sub-optimal choices by manufacturers and retailers and on economically unproductive activity. Raising the excise tax will allow these resources to be captured by the state and be spent on investment and on providing additional goods and services. Thus, removing the tied-house restrictions while raising excise taxes such that the price of alcohol remains unchanged will allow the state to reap all the economic benefits of efficient resource allocation without the costs associated with increased alcohol consumption.

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[2] Manning, W. G., L. Blumberg, and L. H. Moulton, 1995. The Demand for Alcohol: The Differential Response to Price. *Journal of Health Economics* 14: 123-48.

A comparison to alcohol consumption trends in the United Kingdom, which has no tied-house restrictions but higher taxes on alcohol[3], indicates that alcohol consumption trends between the United States and the United Kingdom do not diverge significantly. Per capita consumption of pure alcohol between 1961 and 1999 has been, on average, less than 1% higher in the United Kingdom than in the United States. In fact, prior to 1981 when alcohol consumption began declining in the United States (a decline that has little to do with tied-house restrictions, which were in place for almost half a century prior to 1981), per capita pure alcohol consumption in the United States was higher than per capita consumption in the United Kingdom by a little under 1%.

Apart from a modest increase in alcohol consumption, there are also concerns that lifting the tied-house restrictions will lead to a few large manufacturers controlling the market and limiting the choice of alcoholic beverages available to consumers. The extent of reorganization among manufacturers following the repeal of the tied-house regulations is not likely to be very large. Wine and beer manufacturers currently compete along a number of dimensions including production technology, input costs, and marketing. It is unlikely that removing these restrictions is going to result in monopoly behavior that would justify these concerns. However, if it is determined that these concerns are valid, then a combination of simultaneously removing the tied-house restrictions and raising excise tax such that the retail price of the alcohol remains unchanged and using the additional resources to provide subsidies to small wine and beer producers would result in a more efficient allocation of resources. The state would be able to capture resources currently being wasted under the tied-house restrictions and spend it on encouraging small beer and wine manufacturers.

It should be noted that even while producing a positive net economic impact, removing tied-house restrictions is likely to have an adverse effect on sections of the alcoholic beverage industry.

Wholesalers, whose function is to purchase products from a supplier to sell and deliver to retail establishments, may face a drop in business. The traditional functions performed by the wholesaler (supply of alcohol to retailers, collection of data and receipts on sales, etc.) could be

[3] Based on a 1999 analysis conducted by the Institute for Fiscal Studies, approximately 30% of the final price of beer and 51% of the final price of wine consisted of the excise duty and the value-added tax.

taken over by manufacturers and retailers. The extent to which these functions are taken over will depend on the cost to retailers and manufacturers of doing so. It is likely that many manufacturers and retailers will continue to use the service of wholesalers in supplying and distributing alcohol. Wholesalers tend to be locally owned and licensed businesses with a strong local network. However, in some cases, it is possible that these functions will be taken over by manufacturers and retailers, putting some wholesalers out of business.

Small producers could also face a decline in sales. By allowing all manufacturers to supply directly to retailers, removing the tied-house regulations will remove the advantage Virginia farm wineries have over other types of wine manufacturers. The increased competition, both from in- and out-of-state wine manufacturers could lead to a decline in sales. In addition, removing the tied-house regulations is also likely to put these producers at a disadvantage compared to larger manufacturers in terms of the promotions, incentives, and marketing strategies to promote their brand of wine or beer. For example, large manufacturers may find it easier to operate retail establishments such as restaurants and bars that sell and promote only their brand of beer or wine. However, this impact is likely to be limited somewhat by the fact that a large chunk of wine and beer sales occur at grocery stores, convenience stores, and drug stores. In fact, it is estimated that over 70% of beer sales occur at such establishments. As discussed in the previous section, these establishments are less likely to be influenced by large manufacturers and more inclined to provide their customers with a range of choices in the type and brand of alcohol they stock. However, it remains a possibility that small producers will face a decline in sales with the repeal of the tied-house rules.

As mentioned above, if it is determined that small producers are being negatively affected by the repeal of the tied-house rules, a combination of simultaneously removing the tied-house restrictions and raising excise tax such that the retail price of the alcohol remains unchanged and using the additional resources to provide subsidies to small wine and beer producers will result in a more efficient allocation of resources than under the tied-house regulations.

Estimated Economic Impact of the Proposed Changes:

Tied-house regulations are required under federal and state law. Thus, while these regulations cannot be completely done away with, the proposed changes ease some of the tied-

house rules currently in place. Further loosening of these restrictions, to the federal standard and beyond, is likely to produce even larger economic benefits.

(1) The proposed regulation eliminates the restriction on merchandising activities (such as restocking and rearranging stocks of wine and beer) by alcoholic beverage wholesalers on Sundays, except in localities that have ordinances restricting the sale of alcoholic beverages on Sundays. Under the existing regulations, merchandising activities by wholesalers are prohibited on Sundays in all localities.

The proposed change is likely to have a net positive economic impact. Alcohol is currently sold on Sundays in all localities in the Commonwealth, except for a few localities with local ordinances specifically restricting alcohol sales. According to ABC, only a small fraction of localities, mainly in Southwest Virginia, currently prohibit Sunday sales of alcohol. The proposed change will not affect these localities. For all other localities, the proposed change will make it easier for wholesalers to conduct merchandising activities. By allowing wholesalers to conduct merchandising activities on seven rather than six days a week, the proposed change is likely to allow wholesalers to manage their inventories in a more efficient and timely manner and produce some economic benefits.

(2) The proposed regulation allows wine and beer removed from the shelf for quality control purposes to be replaced with wine and beer of identical quantity and brand but not necessarily with identical packaging. The existing regulation requires that the replacement alcohol has identical packaging as the alcohol being removed. The requirement was intended to ensure that switching occurred only for quality control purposes and not for the purpose of promoting one brand over another. DHCD believes that this provision is no longer necessary and that the intended aim of the regulation will continue to be satisfied even without the identical packaging requirement.

The proposed change is likely to have a net positive economic impact. By allowing wholesalers to replace wine and beer removed from the shelf for quality control purposes with an identical quantity and brand but not identical packaging, the proposed change increases the flexibility of wholesalers in restocking and merchandising activities. Moreover, manufacturers will be able to change their packaging without having to account for the fact that some of their merchandise will have to be replaced due to quality control issues. This, in turn, is likely to lead

to better inventory management. The additional economic benefits are likely to accrue without any significant additional costs. Removing the identical packaging provision is not likely to compromise the ability of the regulation to maintain a separation between manufacturers/wholesalers and retailers. Wholesalers will continue to be required to replace the wine or beer with more of the same brand and quantity, limiting the chances of them promoting one brand over another.

(3) The proposed regulation permits the use of a single invoice for sales of alcoholic and non-alcoholic beverage merchandise to retailers as long as the items are separately identified and totaled. Under the existing regulation, wholesalers are required to use separate invoices for sales of alcoholic and nonalcoholic beverage merchandise to retailers.

The proposed change is likely to have a small net positive economic impact. By allowing both types of sales to be reported on the same invoice, the proposed change is likely to ease the reporting requirements for wholesalers. At the same time, the proposed change will not inhibit ABC's ability to enforce the regulation, i.e., ABC's ability to ensure that wholesalers do not provide nonalcoholic beverage merchandise at below-cost prices in order to induce retailers to promote their alcoholic beverages. To the extent that the proposed change eases the reporting requirements without impairing ABC's ability to enforce the regulation, it is likely to produce some economic benefits.

(4) The proposed regulation removes the provision requiring that retailers pay wholesalers a minimum deposit per container of beer sold by the wholesaler to the retailer. The existing regulation establishes minimum deposit charges on containers sold to the retailer. The regulation also requires that the retailer pay the minimum deposit charge to the wholesaler in cash and prior to any beer being delivered. According to ABC, the Alcoholic Beverage Control Board decided to eliminate the provision as it is not currently being enforced or administered by the department.

The proposed change is not likely to have a significant economic impact. Wholesalers can still charge a deposit for every container sold. Following the implementation of this regulation, wholesalers that choose not to charge any deposit are likely to incorporate the risk, and hence the cost, of containers being broken or unreturned into the price of the beer. To the extent that the proposed regulation increases the flexibility of wholesalers and retailers in dealing

with the risk of containers being broken and/or unreturned, the proposed change could produce some small economic benefits.

(5) The proposed regulation raises the maximum wholesale value of bottle or can openers on which advertising matter regarding alcoholic beverages appears that manufacturers, bottlers, or wholesalers can give retailers from $5 to $10. The current $5 limit was established in 1992. The intent behind limiting the value of can and bottle openers provided complimentary to retailers is to prevent manufacturers, bottlers, and wholesalers from offering retailers expensive openers as inducement to promote their alcoholic beverages (according to ABC, some can and bottle openers can cost hundreds of dollars). ABC believes that a $10 limit is sufficient to cover the cost of most simple bottle and can openers.

The proposed change is not likely to have a significant impact. Manufacturers and wholesalers will still be allowed to provide complimentary can and bottle openers to retailers. The increase in the maximum wholesale value of these openers is not likely to affect the number and type of can and bottle openers provided complimentary to retailers (adjusting for inflation since 1992, $6.56 in 2003 would be equivalent to $5 in 1992). More expensive and elaborate openers that could be considered a form of inducement will still be prohibited under the proposed regulation.

(6) The proposed regulation eliminates the restriction on the number of wines and beers that can be listed on clip-ons and table tents provided by manufacturers, wholesalers, or bottlers to retailers. Currently clip-ons and table tents are restricted to listing just four wines or four beers. According to ABC, the proposed change is intended to make the treatment of wines and beers in this regard consistent with the treatment of distilled spirits. Clip-ons and table tents have no restrictions regarding the number of spirit brands listed on them.

The proposed change is likely to have a small net positive economic impact. By removing provisions in the existing regulation that provide a competitive advantage to distilled spirits compared to wines and beers, the proposed change is likely to result in a more efficient allocation of resources. However, the extent of the efficiency gain is likely to be small. Differences in rules regarding the listing of alcoholic beverages is not likely to have significantly impaired the competitive advantage or disadvantage of wines and beers relative to distilled

spirits. To the extent that the proposed change does improve efficiency, it is likely to produce some economic benefits.

(7) The proposed regulation eliminates the provision prohibiting manufacturers and wholesalers from providing retailers with business entertainment requiring overnight stays and instead increases the maximum amount spent on business entertainment in a 24-hour period from $200 to $400. Under the existing regulation, routine business entertainment requiring an overnight stay is prohibited and manufacturers and wholesalers are limited to spending a maximum of $200 on any employee of a retail licensee during a 24-hour period. According to ABC, the limit was raised to $400 based on federal tied-house rules.

The proposed change is likely to have a net positive economic impact. The intent of provisions limiting business entertainment offered to retailers is to prevent manufacturers and wholesalers from offering retailers business entertainment activities as inducement to promote their alcoholic beverages. In that context, the provision prohibiting overnight stays seems excessive. A limit on the amount that manufacturers and wholesalers can spend on these activities will achieve the intent of the regulation while increasing the flexibility that manufacturers, wholesalers, and retailers have in engaging in various types of business entertainment activities. Thus, to the extent the proposed change provides additional flexibility without violating the intent of the regulation, it is likely to produce some economic benefits.

Businesses and Entities Affected

The proposed regulation will affect manufacturers, bottlers, wholesalers, and retailers operating in Virginia. Wholesalers will be able to conduct merchandising activities on Sundays in most localities, replace wine and beer removed from the shelf for quality control purposes to with alcohol of an identical quantity and brand but not with identical packaging, and report alcoholic and nonalcoholic beverage merchandise sales on a single invoice. Retailers will not be required by regulation to pay minimum deposit charges per container sold to them by wholesalers. Manufacturers, wholesalers, and bottlers will be allowed to provide retailers with complimentary can and bottle openers valued at up to $10, clip-ons and table tents listing more than four wines or beers, and business entertainment in a 24-hour period valued at up to $400 (including overnight stays).

According to ABC, there are approximately 14,000 such entities. Of these, retail licensees account for a little under 13,000.

Localities Particularly Affected

The proposed regulation affects all localities in the Commonwealth.

Projected Impact on Employment

The proposed regulation is not likely to have a significant impact in employment in Virginia.

Effects on the Use and Value of Private Property

The proposed regulation is likely to have a positive impact on the use and value of private property. By easing some of the restrictions on when merchandising activities can occur and increasing the flexibility in how manufacturers, wholesalers, and retailers can interact, the proposed changes are likely to lower operating costs and raise the asset value of these businesses. Some smaller manufacturers and wholesalers may see a decline in their asset values as they find themselves unable to compete with larger businesses. For example, smaller businesses may find it harder to spend $400 per retail licensee employee on business entertainment than larger businesses might.