Alcoholic Beverage Control

The Issue

Very often governments enact economic regulations under the justification that the restriction on free markets is necessary for the protection of the public. However, as often as not, the regulations are in fact enacted at the behest of entrenched market participants seeking protection from competitors. How should public officials respond when an enacted solution is demonstrated either to have no effect whatsoever or perhaps even to make the situation worse? In an ideal world, the government would repeal the policy and let liberty reign again, but as Texas' restrictions on alcoholic beverages show, entrenched interests often interfere.

Following the repeal of Prohibition, Texas adopted a "three-tier system" for the regulation of alcohol, so called because it isolates the different levels of the industry—manufacturing, distribution, and retail—from one another. The Texas Alcoholic Beverage Code plainly states that it is "the public policy of this state . . . to maintain and enforce the three-tier system." Thus, as a general rule, businesses of one category cannot share an ownership interest in a company that belongs to another; nor can they coordinate activities. Each tier must remain independent. The rules promulgated and enforcement actions taken by the Texas Alcoholic Beverage Commission (TABC) are intended to maintain these distinctions, but as is so often the case, the enforcement of arbitrary laws becomes arbitrary itself.

Over time, the three-tier system has put Texas distributors in a favored position. The code permits certain breweries to self-distribute their product if they do not manufacture more than 125,000 barrels annually, but otherwise alcohol manufacturers must contract with a licensed distributor if they wish to sell their product or expand their business. The law imposes strict constraints on the form these agreements may take. As per §102.51, Alcoholic Beverage Code, the contract must be exclusive, in that the distributor has the sole right to sell the product inside a given territory; "a manufacturer may not assign all or any part of the same sales territory to more than one distributor." In addition, this agreement is open-ended. As per §102.74, the manufacturers may not "cancel, fail to renew, or otherwise terminate" their relationship with a distributor "unless the party intending such action has good cause."

More recently, the Texas Legislature has made it illegal for manufacturers to sell their territorial rights at all. Manufacturers must instead relinquish these rights to distributors free of charge. Distributors, meanwhile, retain the option of transferring their contract to a competitor for a profit. A coalition of Texas brewers challenged this law, arguing that it 1) violates the Texas Constitution's ban on uncompensated takings and 2) pursues an illegitimate government interest in violation of the Texas Constitution' Due Process Clause. A state judge agreed and struck down the law, but TABC is expected to appeal.

There are two other lawsuits of note: *Cadena Commercial USA v. TABC* and *McLane Company v. TABC*. Both involve the state government's penchant for inconsistently applying the three-tier system. To illustrate, in *McLane Company*, TABC went so far as to deny the plaintiff a distributor's license because its parent company, Berkshire Hathaway, has a 2 percent ownership stake in Walmart, which holds retailer permits in Texas through a subsidiary. This standard has become known as the "One Share Rule." It holds that a company violates the three-tier distinction if it has any interest in a business of a different tier, even if it merely owns a single share. Followed to its illogical conclusion, the One Share Rule would endanger the license of virtually every approved manufacturer, distributor, and retailer in the state since anyone publicly traded or who provides an employee pension fund could find themselves in breach. TABC avoids this absurdity by applying the rule selectively. Established market players receive a pass. Prospective competitors confront a hostile frontline defense.

The Arguments

Multiple justifications for Texas' three-tier system exist. One is that the three-tier system insulates and protects the market from being dominated by a single supplier. In other words, the argument is that the three-tier system is in fact pro-competition because it prevents vertical integration. No single company can gain full control over the supply chain. The market is instead filled with smaller outfits, who vie for customers with lower prices and innovative products. The result, according to supporters, is a market that is more conducive to responsible and temperate alcohol consumption.

However, even if having a strict division between manufacturing, distribution, and retail thwarted the creation of an industry conglomerate, how does forcing brewers into exclusive contracts with distributors further that interest? Wouldn't that create a monopoly of a different type? Additionally, the benefits of the free market arise because parties have the right to withdraw their business. This puts pressure on both sides to stay honest and keep attentive of their business partners. How does prohibiting the cancelation or non-renewal of a contract aide in that endeavor? Wouldn't it remove the distributor's incentive to do right by both the manufacturer and the consumer? The demand that the manufacturer surrender their distribution rights certainly does not seem necessary or even pursuant to a free and open market. There, the only beneficiary is the middleman who is no longer obligated to pay for the privilege of profiting from someone else's creation.

Taken altogether, the lopsided restrictions and unequal enforcement suggest that the purpose of Texas' three-tier system is not anchored to a concern over vertical integration. Instead of being based on the fear of monopoly and the impact such a monopoly would have on responsible alcohol, the regulation of alcohol in Texas is in fact a system of protection for entrenched incumbents that serves as an indirect corporate subsidy to distributors.

Recommendations

- Eliminate Texas' three-tier system of alcohol regulation.
- Interpret and enforce the regulations controlling alcohol beverages consistently and in manner that does not favor established companies at the expense of competitors.

Resources

Guide for Manufacturers, Wholesalers, Distributors & Retailers of Alcoholic Beverages in Texas, Texas Alcoholic Beverage Commission (Sept. 2013).

Live Oak Brewing Co., LLC v. TABC, Plaintiffs' Original Petition, Application for Injunctive Relief, And Request for Disclosure (Dec. 2014).

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