The Cost of Curbing Externalities with Market Power: Alcohol Regulations and Tax Alternatives

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September 25, 2024*

Abstract
Products with negative externalities are often subject to regulations that limit competition. The single-product case may suggest that it is irrelevant for aggregate welfare whether output is restricted via corrective taxes or limiting competition. However, when products are differentiated, curbing consumption through market power can be costly. Firms with market power may not only reduce total quantity, but distort the purchase decisions of inframarginal consumers. We examine a common regulation known as post-and-hold (PH) used by a dozen states for the sale of alcoholic beverages. Theoretically, PH eliminates competitive incentives among wholesalers selling identical products. We assemble unique data on distilled spirits from Connecticut, including matched manufacturer and wholesaler prices, to evaluate the welfare consequences of PH. For similar levels of ethanol consumption, PH leads to substantially lower consumer welfare (and government revenue) compared to simple taxes, because it distorts consumption choices away from high-quality/premium brands and towards low-quality brands. Replacing PH with volumetric or ethanol-based taxes could reduce consumption by 10-11% without reducing consumer surplus, and roughly triple tax revenues.

Keywords: Excise Tax, Pigouvian Tax, Tax Efficiency, Regulation, Vertical Restraints.

JEL Classification Numbers: H21, H23, H25, L12, L13, L42, L51, L66, L81, K21.

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*This replaces a previous draft circulated under the title "The Price of Liquor is Too Damn High". The authors thank seminar participants at Stanford, Columbia, Yale, Ohio State, Harvard, Kellogg, Wharton, NYU Law, NYU Stern, Drexel, Boston College, Dartmouth, INSEAD, UBC, Wisconsin, Cornell; and conference participants at Utah WBEC, FTC Microeconomics, and IIOC. We have benefited from many useful discussions from: Michael Riordan, Kate Ho, John Asker, Katja Seim, JF Houde, Alan Auerbach, Daniel Shaviro, Robin Lee, Chris Nosko, Juan Carlos Suaŕez Serrato, Rob Porter, Judy Chevalier, Jacob Burgdorf, Julie Mortimer and Adam Cole. Any remaining errors are our own. Researchers' own analyses calculated (or derived) based in part on data from Nielsen Consumer LLC and marketing databases provided through the NielsenIQ Datasets at the Kilts Center for Marketing Data Center at The University of Chicago Booth School of Business. The conclusions drawn from the NielsenIQ data are those of the researchers and do not reflect the views of NielsenIQ. NielsenIQ is not responsible for, had no role in, and was not involved in analyzing and preparing the results reported herein.

1. Introduction

The manufacture, distribution, and selling of alcoholic beverages are big business in the United States, with sales exceeding $250 billion in 2022. Alcohol markets are also subject to an unusual degree of government intervention. Federal, state, and even local governments levy excise taxes on alcohol, raising more than $18.3 billion annually. Beyond industry-specific taxation, the sale and distribution of alcohol are also tightly regulated at the state and federal levels. A common state regulation is *post-and-hold* (PH), which governs wholesale alcohol pricing in 12 states — more than a third of states where alcohol is not sold by a state-run monopoly. These regulations discourage competition among wholesalers, leading to higher prices and lower output.

The Connecticut PH law we examine requires wholesalers to "post" a uniform price schedule to a state regulator, and then "hold" that price schedule for 30 days. All licensed retailers in the state may purchase at the posted price. Prior to sales taking place, wholesalers are offered a "lookback" period during which they are allowed to match but not undercut competitor prices. Theoretically, we show that PH softens competition and facilitates supra-competitive pricing in the wholesale market. Even when wholesalers offer identical products, the unique iterated weak dominant Nash equilibria of the PH pricing game leads to wholesale prices as high as a single-product monopolist would charge. Empirically, we show that PH leads to unambiguously higher prices, particularly for more inelastically-demanded (higher-quality) products, and that if PH were replaced with simple tax instruments, the state could both reduce alcohol consumption and increase consumer surplus.

Understanding these policies is particularly relevant now, as Courts of Appeals are split on whether PH laws constitute a violation of the Sherman Act.[1] In 2022, the Federal Trade Commission (FTC), Department of Justice Antitrust Division (DOJ), and U.S. Treasury Department (TTB) issued a joint report on competition in alcoholic beverage distribution that included a section largely critical of post-and-hold policies (US Department of Treasury, 2022). However, in 2024, the agency is expected reverse course and file a Robinson-Patman suit against alcohol wholesaler Southern Glazer's for offering quantity discounts to large retailers (and allegedly harming small retailers). In a number of speeches, FTC Commissioner Bedoya has said "there is not one empirical analysis showing that Robinson-Patman actually raised consumer prices."[2] One interpretation of PH is that it provides a mechanism to implement the ban on wholesale price discrimination enshrined in the Robinson-Patman Act, so that all retailers face uniform but elevated prices.[3] A less charitable interpretation is that PH provides a mechanism for price coordination among wholesalers and is an example of regulatory capture. In Connecticut, spirits wholesalers spend nearly twice as much on state-level campaign contributions as wholesalers in California, a state with more than 10 times the

[1] Courts have found that laws similar to PH violated the Sherman Act in: California (1980), Massachusetts (1998), Maryland (2004), Washington (2008); and upheld them in New York (1984) and Connecticut (2019).

[2] See `https://www.ftc.gov/system/files/ftc_gov/pdf/returning_to_fairness_prepared_remarks_commissioner_alvaro_bedoya.pdf`

[3] In Appendix D, we show that PH states have fewer retail stores and lower employment, suggesting it does little to benefit small retailers.

population, but relatively competitive distribution. In fact, only Texas saw more political spending by spirits wholesalers than the state we study.[4]

At first glance, outsourcing price increases to private firms might seem like an attractive way to limit alcohol consumption and the associated negative externalities. Intuition from the single-product case suggests that it is irrelevant from a total welfare perspective whether we restrict supply via a Pigouvian tax or through increased market power (perhaps from lax merger approval, weaker antitrust enforcement, or market designs like PH).[5] Indeed, this argument is made by proponents of the "Green Antitrust" movement for allowing consolidation (and sometimes coordination) among fossil fuel companies, and restricting "excessive competition" has been a key feature of market design in the legalization of marijuana.[6] The interaction of market power and taxes is also a concern in attempts to address the "internalities" of sugar-sweetened beverages (Allcott et al., 2019; Dubois et al., 2020; O'Connell and Smith, 2022).

However, the intuition from the single-product case fails when products are differentiated. Put simply, we can think about alcoholic beverages as a bundle of two characteristics: ethanol and branding/quality. For example, the cheapest plastic bottle vodka and the most expensive Scotch might contain equal amounts of ethanol but differ vastly when it comes to consumer perceptions of quality or willingness to pay. A social planner concerned only with limiting the negative externalities would levy a Pigouvian tax on ethanol alone. A firm with market power recognizes that if consumers value both characteristics, it is optimal to "tax" both relative to their elasticities, leading to higher prices on products that consumers value for non-ethanol attributes. Market power may lead not only to markups on premium products that are *too high* but markups on low-end products that are *too low*.

This means that consumers who substitute from premium products to inexpensive ones due to PH prices may consume similar amounts of ethanol but be worse off. We show that taxes — even simple tax instruments such as a single-rate sales tax or ethanol tax — can maintain the same aggregate ethanol consumption as PH while increasing consumer surplus by more than 11%. Consumer surplus gains stem from flattening the difference between price and marginal cost across products with the same ethanol content, allowing consumers to shift away from low-priced value brands and towards premium products, leaving many significantly better off. The obvious additional benefit of using taxes instead of market power to limit consumption is that government revenue increases nearly threefold.

To assess the welfare implications of PH and tax alternatives, we assemble new, unique data

[4] Campaign contributions are the authors' tabulations of data from `https://www.followthemoney.org` .

[5] Levy et al. (2021) discuss public health externalities regarding the FTC investigation into the merger of cigarette maker Altria and leading e-cigarette (vape) manufacturer Juul.

[6] See Hollenbeck and Giroldo (2021); Thomas (2019) on entry restrictions in marijuana markets; Hollenbeck and Uetake (2021) on the interaction between taxes and market power in marijuana; and Hansen et al. (2020) for analysis of a (Pigouvian) "potency tax". For Green Antitrust see Kingston (2011) and Linklaters (2020) in favor and Schinkel and Treuren (2020) against.

from the Connecticut Department of Consumer Protection and private data sources. These data track the monthly prices of spirits products at the manufacturer, wholesaler, and retailer level, and measure shipments from manufacturers to wholesalers in Connecticut from August 2007 to June 2013. Using these data, we show that retail spirits prices are higher in Connecticut than elsewhere, particularly for premium products, and that spirits consumption in Connecticut is skewed towards "lower-end" products despite it being one of the wealthiest states in the country. Following wholesale prices at the product level over time reveals that wholesalers price in parallel with little to no price dispersion, as we would expect given the incentives created by PH.

Combining the price and quantity data, we estimate a model of demand for spirits at the wholesale level that allows for correlated preferences among product categories such as gin or vodka, and heterogeneous preferences over price, package size, and overall demand that vary with income. In addition to matching aggregate purchases, we also match moments based on observed wholesaler markups and individual purchases by income. Our estimates show that the least-expensive products, which are consumed more heavily by lower-income households, feature both more elastic demands and more substitution to the outside option, making them attractive targets for reducing ethanol consumption. Unfortunately, firms with market power set the lowest markups on these products.

We assume that absent the PH system, the wholesale tier would become perfectly competitive, and use our demand estimates to compare the welfare effects of alternative taxes. We consider: an *ad valorem* sales tax, an ethanol tax like the one the U.S. federal government imposes; a volumetric tax, which most states currently employ; and a minimum price per unit of ethanol. These counterfactuals make clear that PH imposes steep welfare costs by distorting inframarginal purchase decisions. The state could, for example, reduce ethanol consumption by nearly 13% without reducing consumer surplus if it replaced PH with ethanol taxes. Meanwhile, revenue from alcohol taxes would nearly triple. If revenues scaled similarly across PH states, this would amount to an additional $1B in tax revenue. Ethanol price floors, on the other hand, could reduce ethanol consumption by a quarter without reducing consumer surplus.

Our counterfactuals also yield interesting insights into the effectiveness of different tax instruments. Because we focus exclusively on distilled spirits, there is little distinction between taxes on volume and taxes on ethanol content (most products are around 40% alcohol by volume).[7] We define the frontiers of the consumer surplus/tax revenue trade-off and consumer surplus/ethanol consumption (negative externality) trade-off by considering product-specific (Ramsey-style) taxes. We find that conventional *ad valorem* taxes are reasonably close to the frontier that trades off consumer surplus against additional tax revenue, albeit at significantly higher levels of ethanol consumption than the Ramsey-like alternative. Likewise, we find that a price floor per unit of

[7]If we included beer and wine in addition to distilled spirits, this would likely not be the case (see Griffith et al. (2019)) though our previous work Conlon et al. (2024) suggests these may be distinct groups of customers in the United States.

ethanol is quite close to maximizing consumer surplus per unit of ethanol consumed, though not particularly effective at raising revenue. This provides a new interpretation of the objectives behind the minimum ethanol unit price enacted in Scotland (Griffith et al., 2022).

Our main results assume that absent the PH system, the wholesale tier would become perfectly competitive. An obvious criticism is that it is not costless for wholesalers to distribute products. We find that allowing for wholesalers to incur additional marginal costs of \$1/L or \$2/L (compared to existing price-cost margins of around \$3/L) would not significantly affect our welfare results, but would reduce the amount of additional tax revenue that could be collected. (A per-liter tax and a per-liter markup or distribution cost are effectively isomorphic; the welfare gains come from having firms *not* price to the own-elasticity). Likewise, an additional concern might be that profit-maximizing manufacturers could respond to a competitive wholesale tier by increasing prices and thus "undoing" some of the benefits of increased competition and higher taxes, a concern similar to one raised in Miravete et al. (2020)). We find that allowing manufacturers/distillers to adjust prices increases their profits by as much as 30%, and slightly reduces the additional tax revenue that can be raised with little impact on welfare.

While it may be somewhat unsurprising that replacing PH and its peculiar incentives with taxes yields efficiency gains, the equilibrium model we estimate provides two key sets of insights. First, estimating demand parameters by matching observed markups reveals which product prices to raise in order to reduce alcohol consumption most efficiently. Because diversion to the outside good and own-price elasticities are highest for low-end products, unlike PH pricing, taxes act to raise these prices most to curb consumption. To the degree that problem drinkers disproportionately consume low-quality products (evidence suggests they do), raising these prices may be even more effective than our estimates suggest at curbing the externality. Second, understanding the price sensitivity and allocation of consumers across products uncovers the distributional impacts of alternative tax policies that differentially change the relative prices of high- and low-end products. For example, much of the benefits of replacing PH with commonly used volumetric or ethanol taxes accrue to the highest-income households.

Our findings suggest that PH is a costly way to achieve the objective of constraining alcohol consumption, and other policies could more effectively curb consumption with benefits for both consumers and government coffers. Moreover, we can achieve these gains with simple, commonly employed tax instruments such as taxes on volume or ethanol content. More broadly, our findings suggest that using market power to address negative externalities can be inefficient, especially when products are differentiated.

2. Alcohol Regulations and Taxes in the US

2.1. State regulations regarding alcoholic beverages

While the federal government imposes substantial taxes on alcoholic beverages, the regulation of alcoholic beverage markets is almost wholly the purview of state governments.[8] Nearly all states that allow alcohol to be sold by private firms have instituted a *three-tier* system of distribution, in which the manufacture, distribution, and sale of alcoholic beverages are vertically separated by law. A common feature of nearly all systems is that retail firms (bars, restaurants, supermarkets, and liquor stores) must purchase alcoholic beverages from an in-state wholesaler.

In 18 states, known as *control states*, the state directly operates the wholesale distribution or retail tier and, in some cases, does both. In some control states, the state monopoly applies to all alcoholic beverages; in others, it applies to distilled spirits, not wine or beer.[9] Recent empirical work has focused on these control states and on understanding the behavior and welfare consequences of state-run monopolies. Miravete et al. (2020) study Pennsylvania's policy of setting a uniform markup (of over 50%) on all products, and Miravete et al. (2018) shows this uniform markup is set above the revenue-maximizing level. Seim and Waldfogel (2013) show that Pennsylvania locates more stores in rural areas and fewer stores in urban areas than a profit-maximizing firm would choose. Other studies have examined how both quantity and prices rose when Washington State privatized its state monopoly. Different authors have offered competing explanations: Illanes and Moshary (2020) explain this phenomenon with increases in product variety, while Seo (2019) focuses on increased convenience and one-stop shopping.

The majority of states are like Connecticut, where private businesses own and operate the wholesale and retail tiers. The three-tier system in *license states* prohibits manufacturers and distillers from selling directly to retailers. These license states often have regulations that restrict not only cross-tier ownership and cross-state shipping, but also a variety of other practices.[10] For example, welfare effects of both exclusive territories and exclusive dealing in the beer industry have been studied in Sass and Saurman (1993); Sass (2005); Asker (2016).

What differentiates spirits wholesaling from beer distribution, at least in Connecticut, is that it involves a substantial amount of *common agency.* As many as four statewide wholesalers often sell the same product. Wholesalers distribute products from multiple competing distillers/manufacturers and do not divide markets geographically. Also, spirits wholesalers in Connecticut (and many other

[8] The 21st Amendment ended Prohibition by turning the power to regulate the import, distribution, and transportation of alcoholic beverages within their borders over to the states, largely exempting their regulations from scrutiny under the Commerce and the Import-Export Clauses of the U.S. Constitution. Since then, numerous Supreme Court cases have eroded state control over alcohol policy, as the Court has held that state control of alcohol is subject to federal power under the Commerce Clause, the First Amendment, and the Supremacy Clause, among others.

[9] A few control states, for example, Maine and Vermont, maintain a state monopoly on the distribution and sale of spirits but contract with private firms for retail operations (including pricing).

[10] License states may also impose other restrictions, such as which days alcoholic beverages can be sold; whether supermarkets can sell spirits, wine, or beer; and the number of retail licenses a single chain retailer can hold.

states) have a "duty to deal" and must supply all licensed retailers at posted prices. In other words, the market structure bears many of the hallmarks of competition, but the market outcomes in Connecticut under PH appear anything but competitive.

In Connecticut, under PH, manufacturers and wholesalers must offer the same uniform prices to all purchasers, and quantity discounts are prohibited. This is implemented by requiring manufacturers and wholesalers to provide the regulator with a price list for the following period (usually a month). In Connecticut, prices must be posted by the 12th day of the preceding month, and cannot be changed until the next posting period. However, some PH states, including Connecticut, also allow a *lookback* period, during which prices can be amended —but only downwards, and not below the lowest competitor price for the same item from the initial round. During this period, wholesale firms are able to observe the prices of all competitors. In Connecticut, the lookback period lasts for four days after prices are posted. Many states, including Connecticut, also employ a formula that maps posted wholesale prices onto minimum retail prices. This limits retailers from pricing below cost (with limited exceptions to clear excess inventory).[11]

2.1.1. Legal Environment of Post-and-Hold

The legal status of PH laws has been challenged in several court cases, with different circuit courts drawing different conclusions as to whether §1 of the Sherman Act preempts state alcohol-pricing statutes under the 21st Amendment. In a landmark Supreme Court case, *California Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc* (1980), the court ruled that the wholesale pricing system in California was in violation of the Sherman Act. The California system at the time resembled PH, but with the additional restriction that retail prices were effectively set via a resale price maintenance agreement by wholesale distributors.[12] The court's ruling established a two-part test for determining when state actions are immune to federal preemption: 1. a law must clearly articulate a valid *state interest* (such as temperance) 2. the policy must be *actively supervised* by the state.

Subsequent rulings in other courts have also struck down PH provisions as violations of the Sherman Act. In *Canterbury Liquors & Pantry v. Sullivan* (1998), the district court ruled Massachusetts's post-and-hold scheme was a violation of §1 of the Sherman Act on summary judgment. In Maryland, the Fourth Circuit ruled in favor of a large liquor retailer in *TFWS v. Schaefer et al.* (2004, final appeal 2009), ending the state's PH system and ban on volume discounts. The Ninth Circuit's appellate decision in *Costco v. Maleng (2008)* affirmed that Washington state's "post-and-hold scheme is a hybrid restraint of trade that is not saved by the state immunity doctrine of

[11]There is a long history of policymakers being concerned about retailers using alcoholic beverages as "loss leaders." Some states allow a limited number of "post-offs," in which retailers can price below the most recent wholesale price in order to clear inventory. See `https://www.cga.ct.gov/2000/rpt/2000-R-0175.htm` for a list of various state regulations.

[12]It is worth pointing out that prior to the *Leegin* decision in 2007, minimum resale price maintenance was a *per se* violation in the United States.

the Twenty-first Amendment."

In contrast, the Second Circuit (which comprises Connecticut, New York, and Vermont) has twice upheld PH laws, with both decisions focusing on the *lack of coordination* required to establish a §1 collusion case. Writing for the majority in *Battipaglia v. New York State Liquor Authority* (1984), Judge Henry Friendly found "New York wholesalers can fulfill all of their obligations under the statute without either conspiring to fix prices or engaging in 'conscious parallel' pricing. So, even more clearly, the New York law does not place 'irresistible pressure on a private party to violate the antitrust laws in order to comply' with it."

More recently, the Second Circuit's majority opinion in *Connecticut Fine Wine and Spirits, LLC v. Seagull* (2019) focused similarly on the lack of communication between wholesalers:

> Nothing about this arrangement requires, anticipates, or incents communication or collaboration among the competing wholesalers. Quite to the contrary: A post-and-hold law like Connecticut's leaves a wholesaler little reason to make contact with a competitor. The separate, unilateral acts by each wholesaler of posting and matching instead are what gives rise to any synchronicity of pricing.

The Second Circuit's dissenting opinion sharply criticized the majority's reasoning:[13]

> allow[ing] de facto state-sanctioned cartels of alcohol wholesalers to impose artificially high prices on consumers and retailers across all three states in our Circuit...The problem with Connecticut's law is not that it affirmatively compels wholesalers to collude in order to fix prices, but that it provides no incentive – or ability – for wholesalers to compete on price.

As we illustrate with our theoretical model in Section 3, both parties are partially correct. Connecticut's PH system leads to supra-competitive wholesale prices in a one-shot game via unilateral incentives, without requiring any communication or repeated cooperation among the parties.

These disparate circuit court rulings leave PH laws fully legal in some parts of the United States but prohibited elsewhere. The circuit split opens the door for the Supreme Court to resolve the issue, and highlights the importance of understanding the impact of PH laws on pricing behavior and welfare.

2.2. Taxes on Distilled Spirits

Federal, state, and even some municipal governments levy their own excise taxes on distilled spirits. The overwhelming majority of these taxes take the form of specific taxes, which are a fixed dollar

[13] We should disclose that we were not engaged or compensated by any parties in the Connecticut case (or any other case). However, previous versions of this paper were cited by the briefs of several parties, including the theoretical result that PH could lead to prices as high as the collusive prices in a static unilateral effects framework.

amount per unit (either volume or alcohol content), though, in most states, the general sales tax also applies to alcohol purchases.[14]

Federal taxes are remitted by the distiller/manufacturer or upon import.[15] At the federal level, distilled spirits are generally taxed at \$13.50 per proof-gallon, where a proof-gallon is one liquid gallon that is 50 percent alcohol. Most spirits are bottled at 80-proof or 40% alcohol by volume (ABV), and incur \$2.85/L in federal taxes. Flavored spirits (generally 60-proof) incur lower taxes, and overproof spirits (often over 100-proof) pay higher taxes per liter.

Most state excise taxes, on the other hand, are volumetric, meaning they do not vary by alcohol content, and are remitted by the wholesaler. Connecticut's specific tax on spirits was raised from \$4.50 per gallon (\$1.18 per liter) to \$5.40 per gallon (\$1.42 per liter) on July 1, 2011, and again to \$5.93 per gallon (\$1.56 per liter) on October 1, 2019. We use the timing of the tax increase as an instrument in our analysis. Like most states, Connecticut includes alcohol products in its general retail sales tax base. Connecticut also increased its general sales tax rate from 6% to 6.35% when it raised its excise tax on alcohol.

As a share of the overall retail price, these excise taxes can be large, particularly for the least expensive products. For example, a 1.75L bottle of 80-proof vodka in Connecticut (after 2011) includes \$7.48 in combined state and federal taxes. At the low end of the spectrum, a 1.75L plastic bottle of *Dubra Vodka* (one of the best-selling and least expensive products) typically sells for \$11.99 at retail; taxes therefore account for greater than 60% of the price. On the other end of the spectrum, a 750mL bottle of premium vodka (*Grey Goose* or *Belvedere*) or Scotch whisky (*Johnnie Walker Black*) might retail for over \$40, of which only \$3.21 (about 8%) would go to taxes.

3. A Theoretical Model of Post and Hold

Our theoretical model shows that the post-and-hold system used by Connecticut functions like a "price matching game." This eliminates the incentive to cut prices and increase market share. Even when multiple firms sell identical products, the iterated weak-dominant strategy is to set the monopoly price and then match any competitor's price in the second stage. This will lead to higher prices when compared to competitive wholesale markets. We consider both a simple single-product example in Section 3.1 and also a more realistic example with multi-product firms in Section 3.2.

3.1. PH with a Single Homogenous Good

Consider the following two-stage game among wholesale firms (designed to resemble the actual PH process in Connecticut described in Section 2). In the first stage, each wholesaler submits a uniform price to the regulator. Then, the regulator distributes a list of all prices to the same

[14]This applies largely to license states. In control states, it is hard to differentiate retailer markups from *ad valorem* taxes.

[15]Imported spirits may also be subjected to additional *ad valorem* tariffs. In October 2019, President Trump imposed a 25% tariff on Scotch Whisky imports, which was later suspended for five years in June 2021 by the Biden administration.

wholesale firms. During the second stage, firms are allowed to revise their prices with two caveats: a) prices can only be revised downwards from the first stage price, and b) prices cannot be revised below the lowest competitors' price for that item. Only after this second stage is demand realized. To start, we focus on the case of a single product:

1. **Price Posting:** Each wholesale firm $f \in \mathcal{F}$ submits an initial price p_0^f to the regulator.

2. **Lookback:** Firms observe all initial prices and may choose any price $p^f \in [\underline{p_0}, p_0^f]$ where $\underline{p_0} = \min_g\{p_0^g\}$ (the lowest initial price among all competitors).

3. **Sales take place:** Only after all prices are amended do sales take place.

Suppose that consumer demand is described by $Q(P)$, where P is the "market price," and firms charging p^f face demand:[16]

$$q^f(p^f, p^{-f}) = \begin{cases} 0 & \text{if } p^f > \min_g p^g; \\ \frac{Q(P)}{\sum_g \mathbb{I}[p^f = \min_g p^g]} & \text{if } p^f = \min_g p^g. \end{cases} \tag{1}$$

If each firm has constant marginal cost mc^f, then in the second stage, firms solve:

$$p^{f*} = \arg\max_{p^f \in [\underline{p_0}, p_0^f]} \pi^f = (p^f - mc^f) \cdot q^f(p^f, p^{-f})$$

which admits the dominant strategy:

$$p^{f*} = \max\{mc^f, \underline{p_0}\}$$

In the second stage, firms match the lowest price from the first stage $\underline{p_0}$ as long as it is above marginal cost. Now consider the first-stage game under the additional assumption of symmetric marginal costs $mc^f = mc$.[17] Given the dominant strategy in the second stage, a (symmetric) subgame perfect Nash equilibrium choice for p_0^f is:

$$p_0^f \in [mc^f, p_m^f]. \tag{2}$$

One possible (symmetric) equilibrium is the monopoly pricing equilibrium. That is, all firms set $p_0^f = p_m$. Here, there is no incentive to deviate. In the second stage, all firms split the monopoly profits (symmetric costs rule out limit pricing). Cutting prices in the first stage merely reduces the

[16]This is just homogenous goods Bertrand so that firms charging above the "market price" sell zero units and other firms split the market evenly. Later, we consider the case when there is both intra-brand and inter-brand competition.

[17]In Appendix A, we consider the case of heterogeneous marginal costs. In this case, we order the firms by marginal costs and must also check each "limit price", the highest possible price (below the monopoly price) for each possible number of firms. In the case where costs are "sufficiently similar", and demand is "well-behaved", we can rule out most cases of limit pricing.

size of the profits *without any change to the division.* Any upward deviation in the first stage has no effect because it doesn't change $\underline{p_0}$.

Another possible equilibrium is marginal cost pricing. Here, there is no incentive to cut one's price and earn negative profits. Also, no single firm can raise its price and increase $\underline{p_0}$ as long as at least one firm continues to set $p_0^f = mc$. There is a continuum of (symmetric) equilibria in between.

While it might appear to be ambiguous as to which price is played in the initial period, there are several reasons to think that the monopoly price is the most likely. First, this is obviously the most profitable equilibrium for all of the firms involved; that is, the monopoly pricing equilibrium Pareto dominates all others. However, Pareto dominance is often unsatisfying as a refinement because it need not imply stability. Therefore, we also show that the monopoly price is the only equilibrium to survive iterated weak dominance.

Proposition 1. *In the absence of limit pricing (or under symmetric marginal costs $mc^f = mc \, \forall f$), the unique equilibrium of the single-period game under iterated weak dominance is the monopoly price: $\sigma(p_0^f, p^f) = (p_m^f, \underline{p_0})$ where $\underline{p_0} = \min_f p_0^f$. (Proof in Appendix A.1).*

An iterated weak dominant strategy is for firms to set their first-stage prices at their perceived monopoly price $p_m^f(mc^f)$; and, in the second stage, match the lowest of the prices from the first stage (as long as price exceeds marginal cost) $p^f = \max\{mc^f, \underline{p_m}\}$. While we could extend the analysis to repeated games because the monopoly price attains the maximum profits in the one-shot game, such analysis would be superfluous here.[18]

3.2. PH with Heterogeneous Costs and Multiproduct Firms

Consider a multi-product wholesale firm $f \in \mathcal{F}$, which chooses prices for all products they sell $j \in \mathcal{J}_f$. A key feature of our market is that multiple wholesalers sell identical products (i.e., *Smirnoff Vodka 750mL*). Following the single-product example in Section 3.1, an iterated weak-dominant strategy is for f to set the initial price p_j^f as if it can do so unilaterally, and then simply to match the lowest competitor price on that product in the second stage (assuming it exceeds marginal cost).

We relax the assumption that firms setting equal prices $p_j^f = p_j^g$ split the market equally and instead allow firms to split the market for each product in a known proportion $\gamma_j^f \perp Q_j(\mathbf{P})$. Now, firm f's sales of product j are given by $q_j^f(\mathbf{P}) = \gamma_j^f \cdot Q_j(\mathbf{P})$, where $Q_j(\mathbf{P})$ represents the total demand for product j, and $\mathbf{P}$ represents the vector of prices for all products available in that period.[19]

[18] A more challenging extension would be to think about a different game where prices are locked in for 30 days at a time, but firms do not have a "lookback period". There the monopoly price need not be the unique iterated weak-dominant equilibrium of the one-shot game.

[19] We still assume that firms which set $p_f > p_g$ sell zero units. The substantive restriction is that γ_j^f is constant and does not depend on prices. In practice, this allows us to estimate γ_j^f from our shipment data.

We write the profits of firm f (if all sellers charge the "market price" P_j) as:

$$\pi_f(\mathbf{P}) = \gamma_j^f \cdot Q_j(\mathbf{P}) \cdot (P_j - mc_j^f) + \sum_{k \in \mathcal{J}_f \setminus \{j\}} \gamma_k^f \cdot Q_k(\mathbf{P}) \cdot (P_k - mc_k^f) \tag{3}$$

If each firm f which sells j could unilaterally set the price, the first order condition of (3) with respect to P_j, and divided by $\gamma_j^f > 0$ would be:

$$\left[Q_j + \frac{\partial Q_j}{\partial P_j}(P_j - mc_j^f) \right] + \sum_{k \in \mathcal{J}_f} \frac{\gamma_k^f}{\gamma_j^f} \cdot \left[\frac{\partial Q_k}{\partial P_j}(P_k - mc_k^f) \right] \geq 0 \tag{4}$$

This is meant to reflect the FOC that governs the initial choice of price for j by f in the first stage. In the second stage, firms should still match the lowest-priced seller (as long as the price exceeds marginal cost). This means that (4) holds with equality for at least one firm (the initial lowest-priced seller), and with inequality (> 0) for the others.

What we would like to do is characterize the equilibrium of these second-stage prices and identify which firm $f \in \mathcal{F}$ is the price-setter in the first stage. In the data, we observe second-stage prices (which are nearly always identical across wholesalers) but do not observe initial prices.[20] We can rewrite (4) to set marginal revenue equal to marginal cost as if firm f could unilaterally choose p_j:

$$p_j^f \left(1 + 1/\epsilon_{jj}(\mathbf{P})\right) = mc_j^f + \sum_{k \in \mathcal{J}_f \setminus \{j\}} \frac{\gamma_k^f}{\gamma_j^f} \cdot D_{jk}(\mathbf{P}) \cdot (p_k - mc_k^f) \tag{5}$$

Own-price elasticities ϵ_{jj} will vary across products based on the characteristics of those products (including but not exclusively ethanol content) and the demographics of the consumers who purchase them, with less elastic demands leading to higher markups. The right-hand side of (5) represents the full *opportunity cost* of selling j. In addition to the marginal cost mc_j, when customers leave j as the price rises, some fraction (the diversion ratio) $D_{jk} = \frac{\partial Q_k}{\partial P_j} / \left| \frac{\partial Q_j}{\partial P_j} \right|$ switch to k, with margins $p_k - mc_k^f$, and firm f will capture a fraction γ_k^f (as compared to γ_j^f of the customers of j).[21]

This is important because the firm with the lowest opportunity cost will choose the lowest price p_j^f, and the other firms will simply match this price. In our empirical example, we observe (or can estimate) all of the objects in the bracketed expression from (5) and thus can determine which firm f is the "price setter" for product j. Taking this to data requires the additional assumption that mc_j does not vary by firm. In practice, the wholesalers' marginal costs are determined primarily

[20]Also notice that if a firm reduced its price in the first stage to p'_f so that $\underline{p} \leq p'_f < p_f$, this would have no effect on the market price in the second stage. This is the non-uniqueness of subgame perfect equilibria in (2), whereas the second-stage equilibrium is unique as long as the price-setting firm for each product j doesn't play a weakly-dominated strategy.

[21]See Conlon and Mortimer (2021) for a more detailed explanation of diversion ratios.

by: uniform (by law) manufacturer prices and state excise taxes, both of which we observe.[22]

$$\kappa_{jk} \equiv \frac{\gamma_k^f}{\gamma_j^f}, \text{ such that } f = \arg\min_{f':\gamma_j^{f'}>0} \left[mc_j^{f'} + \sum_{k \in \mathcal{J}_{f'} \setminus \{j\}} \frac{\gamma_k^{f'}}{\gamma_j^{f'}} \cdot D_{jk} \cdot (p_k - mc_k) \right] \tag{6}$$

$$p_j = \frac{1}{1 + 1/\epsilon_{jj}} \cdot \left[mc_j + \sum_{k \in \mathcal{J} \setminus \{j\}} \kappa_{jk} \cdot D_{jk} \cdot (p_k - mc_k) \right] \tag{7}$$

Once we know which firm "sets the price" for each product j, we can re-write (4) in matrix form as (where $\odot$ denotes the Hadamard product):

$$\mathbf{q}(\mathbf{p}) = \big(\mathcal{H}(\kappa) \odot \Delta(\mathbf{p})\big) \cdot (\mathbf{p} - \mathbf{mc}) \tag{8}$$

where the elements of the matrix $\Delta_{(j,k)} = \frac{\partial Q_j}{\partial P_k}$, and the elements of the vector $\mathbf{mc}$ correspond to mc_j^f for the lowest *opportunity cost* firm from (5). Here, the *ownership matrix* has entries $\mathcal{H}_{(j,k)} = \kappa_{jk} = \frac{\gamma_k^f}{\gamma_j^f}$, which can be interpreted as *profit weights* or how the firm setting the price of j treats \$1 of (market-level) profit from k relative to \$1 of (market-level) profit from j. The profit weights depend on the relative share of the market controlled by f for products j and k. Following a long literature in industrial organization, we can solve the linear system in (8) for the (additive) markups:[23]

$$\boldsymbol{\eta} \equiv (\mathbf{p} - \mathbf{mc}) = \big(\mathcal{H}(\kappa) \odot \Delta(\mathbf{p})\big)^{-1} \mathbf{q}(\mathbf{p}). \tag{9}$$

Even though multiple firms sell identical products in a two-stage game with price matching, we can still recover a mapping from consumer demand for products $(\mathbf{q}(\mathbf{p}), \Delta(\mathbf{p}))$ and price cost margins $(\mathbf{p} - \mathbf{mc})$ using only second-stage prices by constructing the "ownership matrix" of lowest opportunity-cost firms on a product-by-product basis. Our only additional requirement is the assumption that the pivotal firm f for each product j does not play a weakly dominated strategy.[24]

When we take our model to the data in the subsequent section we define wholesale prices as the sum of the additive markup η_{jt} from (9) and the marginal cost (the manufacturer price p_{jt}^m, excise

[22]This seems reasonable because Connecticut is a small and most of the wholesalers are located within a very small geographic region near the center of the state. Allowing for some homogenous (across firms and products) wholesaler cost is a straightforward extension that we consider later on.

[23]See other examples from the IO literature going back to Bresnahan (1987) and Nevo (2001, 2000) for mergers, Villas-Boas (2007) for double marginalization, Miller and Weinberg (2017); Miller et al. (2021) for coordinated effects, and Backus et al. (2021a,b) for partial (common) ownership.

[24]Notably, we don't need to make assumptions about the costs (or off-equilibrium beliefs) of the sellers who are not the lowest opportunity cost wholesaler.

tax τ_{jt}, and any additional marginal cost of wholesaling w_{jt}):

$$p^w_{jt} = \underbrace{p^m_{jt} + \tau_{jt} + \mathrm{w}_{jt}}_{mc_{jt}} + \eta_{jt}. \tag{10}$$

4. Data and Some Descriptive Evidence

In this section, we present several stylized facts and patterns in the data consistent with the theory in Section 3. We show that: (1) Prices are higher in PH states than in other license states. When comparing Connecticut (our PH state) and Massachusetts (a nearby non-PH license state): (2) prices are higher in Connecticut; (3) relative prices are higher for "premium" products; (4) relative shares are lower for "premium" products. Finally, (5) when multiple wholesalers offer a product in a PH state, prices largely move in lockstep.[25]

4.1. Cross State Evidence from Retail Prices

Our first set of stylized facts comes from the NielsenIQ Retail Scanner Dataset (through the Kilts Center at Chicago Booth). These data report weekly unit sales and total revenue for each product (a unique UPC) for a set of retail stores that voluntarily share their data with NielsenIQ. We use the data from 2013 (the final year in our administrative dataset), and compute a volume-weighted average price for each product for the entire year.[26]

To compare prices, we construct an index that measures how the average retail price for a fixed set of products varies across states. Using the 250 best-selling products nationwide, we construct the index value for each state:

$$PI^x = \frac{\sum_{j=1}^{250} p^x_j q^{US}_j}{\sum_{j=1}^{250} q^{US}_j} \tag{11}$$

where q^{US}_j is the nationwide retail quantity of product j (measured in liters) and p^x_j is the per-liter retail price of product j in state x. Figure 1 plots index values for control states, license states with PH, and license states without PH regulations. Dark bars on the left indicate the state excise tax for the national bundle in each license state. Retail prices are always inclusive of the excise tax (but not the general sales tax). We do not separate out excise taxes for control states.

Figure 1 illustrates two key facts. First, PH states feature some of the highest prices. In fact, PH states outrank nearly all other license states with one notable exception being Texas, which

[25] Appendix D also extends panel data analysis by Cooper and Wright (2012) to show that aggregate sales of alcoholic beverages are lower under PH, and employment in the retail sector is also lower under PH.

[26] While coverage across states in the NielsenIQ data for supermarkets is excellent, coverage for liquor stores is imperfect. This is because some control state monopolies don't share data with NielsenIQ at all. In some license states (such as California), supermarkets are allowed to sell distilled spirits, leading to good coverage, while in others, only standalone liquor stores can sell spirits (including New York, New Jersey, and Connecticut). Other license states, such as Rhode Island and Delaware, where NielsenIQ records fewer than 1,000 sales, are excluded from the analysis.

has a different and unusual market structure. Second, price differences are not fully explained by differences in tax rates. PH states have fairly typical tax burdens, ranking roughly in the middle of the distribution of taxes, but are uniformly in the upper third of the price distribution.

A simple way to think about what would happen if we eliminated PH in Connecticut might be to consider another license state as a counterfactual. For example, Illinois has prices that are approximately \$3 per liter lower, while having tax rates that are roughly double those we see in Connecticut. A more obvious comparison for Connecticut is the neighboring state of Massachusetts, which eliminated PH in 1998.[27] The two states are demographically similar, and are likely to have similar local wages and transportation costs. Moreover, much of Connecticut is either in the Boston media market or the shared Hartford-CT/Springfield-MA media market, so we might expect that preferences for distilled spirits might be similar in the two states.[28] However, as Figure 1 suggests, prices are around \$1.90 per liter lower in Massachusetts, while excise taxes are only \$0.35 per liter lower.

In Figure 2, we plot the average retail price per liter in Connecticut against the average retail price per liter in Massachusetts for each brand of vodka in the NielsenIQ data. We focus on vodka because it represents around 45% of the sales volume in each state. Different bottle sizes are indicated by color, and within brand, there is a substantial discount in the per-liter price for larger (1.75L) bottles. If the prices were identical in both states, all points would lie along the 45-degree line shown in solid black. Instead, prices in Connecticut generally exceed prices in Massachusetts. Moreover, the price premium is larger for more expensive products. We can see that budget brand *Popov* is priced similarly in the two states. Meanwhile, Smirnoff, the most popular brand, is subject to a sizable Connecticut premium, and Belvedere, a high-end brand, is subject to an even larger premium. The best-fit line, $P_{CT} = 0.723 + 1.073 \cdot P_{MA}$, indicates that on average, Connecticut consumers pay approximately \$1.45 per liter more for discount vodka, \$2.18 per liter more for mid-tier vodka, and \$3.64 per liter more for premium vodka.[29] (Recall, the tax difference is only a flat \$0.35 per liter).

One important distortion of the PH policy that we might expect: Firms with market power charge relatively higher markups on more expensive products, and thus influence the set of products

[27]There has been some confusion in the literature as to whether Massachusetts is a PH state. Cooper and Wright (2012) report that Massachusetts ended PH in 1998 while Saffer and Gehrsitz (2016) draw their data regarding PH laws from the NIAAA's catalogue of wholesale pricing restrictions (`https://alcoholpolicy.niaaa.nih.gov/apis-policy-topics/wholesale-pricing-practices-and-restrictions/3`) which describes Massachusetts as a PH state. To clarify the status of the PH statute in Massachusetts, we contacted the Massachusetts Alcoholic Beverages Control Commission. The General Counsel of the Massachusetts Alcoholic Beverages Control Commission explained that "The US District Court ruled the post-and-hold provision to be unconstitutional, so while it remains 'on the books,' it is not enforced so licensees do not need to post and hold (although they are still required to post prices). The case on point is Canterbury Liquors & Pantry v. Sullivan, 16 F.Supp.2d 41 (D.Mass.1998), as well as a Massachusetts Appeals Court case recognizing the District Court's ruling [in] Whitehall Company Limited v. Merrimack Valley Distributing Co., 56 Mass. App. Ct. 853 (2002)." As such, we follow Cooper and Wright (2012) and treat Massachusetts as a non-PH state after 1998.

[28]The remainder of southern Connecticut is in the New York media market.

[29]Here, we've defined discount, mid-tier, and premium vodkas as \$10, \$20, \$40 per liter, respectively.

consumers purchase. Again we use Massachusetts as our comparison. In Figure 3, we categorize vodkas based on the *national average* price per liter, and plot the share of sales (by volume) in each price band for each state. The idea is that the national average price captures some objective measure of "quality."[30] The upper panel describes purchase shares by volume for 750mL products, while the lower panel describes 1.75L products. The purchase patterns in Figure 3 show that relative to their Massachusetts neighbors, consumers in Connecticut are more likely to purchase products from the two lowest "quality" groups, and much less likely to purchase products from the two highest "quality" groups.[31] Again, this is purely descriptive, and it may be that preferences for vodka in plastic bottles are higher and preferences for *Grey Goose* are lower in Connecticut for other idiosyncratic reasons.[32] We provide an alternative comparison based on CDFs in Appendix C.1.

4.2. Administrative Data from Connecticut

Our main dataset is meant to capture the universe of distilled spirits sales at the *wholesale level* in the state of Connecticut from July 2007 through July 2013. This dataset has been collected and compiled by us (the authors), and has not been previously analyzed.

The first data source is the monthly price postings from Connecticut's Department of Consumer Protection (DCP). The PH system necessitates that all *wholesalers* submit a full price list for all products they sell.[33] A similar regulation requires that the manufacturers/distillers (firms like Bacardi, Diageo, Jim Beam, etc.) post prices each month.[34] This means that we see monthly product-level pricing for both the *manufacturer* tier and the *wholesale* tier.

There are several challenges related to data construction. The first is that the format of price filings is irregular. While some firms provide spreadsheets, others provide printed PDF reports, and many provide scans of faxed-in price lists. The second challenge is that a single product such as *Johnnie Walker Red* is sold by a single manufacturer (Diageo) but by as many as four wholesalers, and there is no product identifier that links the product between manufacturer and wholesaler or across wholesalers. This means that all of the matching of products and assignment to a unique product identifier must be done primarily by hand. A third challenge is that reporting of product flavors can be inconsistent: we might see shipments of one flavor (Cherry) but price postings only for another flavor (Orange). As different flavors are priced identically, within a brand-size-proof combination, we consolidate multiple flavors so that *750mL Smirnoff Vodka (Flavored)* is a unique product, but "Orange" or "Cherry" is not.

[30] Alternatively, we could think about this as a measure of "expected prices" that is purged of local demand or preference shocks.

[31] A similar pattern holds for 1L bottles, but we exclude these from the analysis since 1L bottles are primarily purchased by bars and restaurants and account for only 4% of retail liquor store sales in Massachusetts and Connecticut.

[32] Another possibility is that consumers in Connecticut drive to Massachusetts to save \$9 on Grey Goose, but not to save \$0.50 on Popov.

[33] Recall that the legislation prohibits quantity discounts, so firms are restricted to *uniform* prices.

[34] Each manufacturer/distiller is the sole seller for each of the brands they produce, unlike the wholesale tier, which is categorized by a high degree of *common agency*.

The most serious limitation of the price-posting data is that we usually don't observe both: (a) the initial price postings; and (b) the amended or revised price postings. In some cases, we see only the initial price posting and some handwritten (or faxed) amendments. In others, we see only initial price postings and don't know whether prices were amended or not. And finally, in other cases, we observe only a list of amendments to prices and no price postings at all. In practice "amended prices" tend to overwrite "initial prices" in the DCP database. When in doubt, we treat price postings as if they are (second-stage) "as amended." This requires some careful data cleaning, and filling prices backwards and forwards when there are gaps.[35] One limitation is that we don't have two separate sets of prices we would need to analyze the two stages of the price-posting process. We can offer anecdotal evidence that when firms amend prices, they are required to list the competitor whose price they "match," and this is verified by the DCP. However, one advantage of the model in Section 3.2 is that we require only the second-stage price from the lowest-opportunity cost seller in order to estimate demand and supply.

The second data source tracks shipments of distilled spirits from manufacturers/distillers/importers to wholesalers. These data were obtained from the Distilled Spirits Council of the United States (DISCUS). The DISCUS data track shipments from member manufacturers – generally the largest distillers – to wholesalers for each product.[36] These distillers constitute 78% of total shipments of distilled spirits (by volume) in the state of Connecticut.[37]

A key aspect of the DISCUS data is that it contains all shipments (of covered brands) to the state of Connecticut. This includes products that ultimately end up in bars and restaurants, as well as those sold in retail liquor stores. Another advantage of the DISCUS data is that we see total shipments not only by product, but also to each wholesaler. This lets us estimate the γ_j^f parameters from our theoretical model in (6) directly from the shipment data. The primary disadvantage is that for less popular products, shipments can be lumpy, with only a handful of shipments per year. For this reason, we focus our analysis primarily at the *quarterly* level of observation, and for the least popular products (one shipment per year or less, around 6% of total sales), we have to apply some further smoothing. For the 21.9% of products not included in our DISCUS sample, rather than exclude them from the analysis, we impute shipments using the NielsenIQ Retail Scanner data totals from 34 stores in Connecticut. We describe the construction of the quantity data in detail in the Data Appendix.

Table 1 reports summary statistics for the 735 products we use in our analysis by category and bottle size.[38] Products are brand-flavor-proof-size combinations, such as *Smirnoff Vodka 750mL* or

[35]We discuss this in detail in our Data Appendix. Some manufacturers tend to post only the prices of products whose prices changed from the previous month, which requires some care in constructing the full sequence of prices.

[36]DISCUS members include: Bacardi U.S.A., Inc., Beam Inc., Brown-Forman Corporation, Campari America, Constellation Brands, Inc., Diageo, Florida Caribbean Distillers, Luxco, Inc., Moet Hennessy USA, Patron Spirits Company, Pernod Ricard USA, Remy Cointreau USA, Inc., Sidney Frank Importing Co., Inc., and Suntory USA Inc.

[37]Some of the largest non-DISCUS members include: Heaven Hill Distillery and Ketel One Vodka.

[38]We restrict the sample using the following criteria: (1) we only consider the 750 best-selling products (99.9% of sales volume); (2) only products whose average wholesale price is below \$60/L (mostly excluding rare Scotch Whisky);

Tanqueray Gin 1L. Vodka is the largest product category, accounting for 208 products, and 44.8% of all spirits liters sold. While a plurality of products are 750mL, it is 1.75L products that account for 56.7% of sales volume. Most products are 80-proof (40% alcohol by volume), and as such proof averages near 80 for most categories and bottle sizes, with some exceptions.[39]

Table 1 also reports the average price and average price-cost margin (or additive markup) net of any taxes: $(p_j - mc_j)$ at each tier of the distribution chain (manufacturer/distiller, wholesaler, and retailer). Table 2 reports similar information except with the average Lerner markup $L = \frac{p_j - mc_j}{p_j}$ instead of the additive markup, and broken out by manufacturer/distiller instead of by size and category. To produce meaningful summary measures across differently-sized products, product prices and margins are measured in per-liter terms, and all means are weighted by liters sold. Our data are unusual because we observe prices at the manufacturer p^m, wholesaler p^w, and retailer p^r level, as well as the excise taxes τ_j paid by wholesalers. This means we directly observe input costs except at the manufacturer level.[40] The largest manufacturer, Diageo, sells 155 products and accounts for 32.7% of sales by volume, and enjoys the highest Lerner markups (around 30% on average).

The most important takeaway from Tables 1 and 2 is that the wholesale tier is significantly more profitable than other tiers. A "typical" product retails for slightly less than $20 per liter, with a breakdown of: $3.97/L of wholesaler margin, $3.07/L of manufacturer margin, $2.71/L of retailer margin, and $1.42 in state and $2.85 in federal taxes.[41] Moreover, prices (per liter) and markups tend to be higher (for all tiers) on 750mL products than on the more popular (and less expensive) 1.75L products. Our counterfactuals will focus on the case where we make the wholesale tier more competitive and instead use taxes to constrain ethanol consumption and address negative externalities.

4.3. Wholesaler Pricing Behavior

Our main focus is the pricing behavior and market power of the wholesale tier. As many as four wholesalers sell identical products, yet each charges a substantial markup above the manufacturer price and also charges identical prices as each other. There are several innocuous possibilities, including the fact that wholesaling activities are costly to produce; maybe they provide valuable ancillary services; or perhaps wholesale firms are substantially differentiated in ways we cannot

(3) we exclude Cordials and Liqueurs (e.g. Triple Sec, Baileys, Kahlua) which are generally 20% alcohol by volume or less and possibly complements rather than substitutes for distilled spirits; (4) we exclude Cognacs (e.g. Hennesey and Courvoisier) because these products contain vintage/age statements and are nearly impossible to match across data sources.

[39] Some popular gins and imported Scotch Whiskies are over-proof. Most flavored vodkas are 60-proof, and flavored rums can be as low as 42-proof (e.g. *Malibu Coconut Rum*).

[40] Manufacturer marginal costs are backed out of the first order conditions using our demand estimates and following the procedure described in Appendix B.1. Retail prices come from the NielsenIQ Scanner Dataset for Connecticut and are available only for select retail stores, while manufacturer and wholesaler prices are statewide.

[41] The remainder being production costs.

observe.

Absent the PH system, a simple way to think about a counterfactual would be if wholesale markups were competed away so $p_j^w = p_j^m + \tau_j$ (manufacturer price plus excise taxes). We plot the wholesale prices and manufacturer prices in Figure 4. Rather than plot the 45-degree line, we plot the zero markup line: $p_j^w = p_j^m + \tau_j$. We see that (after accounting for taxes) wholesaler price-cost margins are larger on more expensive products, with products like *Grey Goose* and *Johnnie Walker Black* having very high price-cost margins. High wholesale price-cost margins are not exclusive to the most expensive products; the mid-priced product *Smirnoff Vodka* (the overall best-seller) also has a high margin, though other popular yet inexpensive products such as *Dubra Vodka* have small markups.

Figure 5 tracks the wholesale (case) prices of up to four different wholesale firms in addition to the manufacturer price for four popular spirits products: Stolichnaya Vodka (1000mL), Tullamore Dew Irish Whiskey (1750mL), Dewars White Label (750mL), and Johnnie Walker Black (1750mL). For each product, the prices set by the different wholesalers move in near lockstep with one another. While one innocuous explanation might be that this synchronous movement simply reflects changes in input prices, the manufacturer prices plotted alongside the wholesale prices do not support this reasoning. Manufacturer prices change only rarely, while wholesale prices move more frequently and together. Instead, it appears that wholesalers are pricing in parallel, which is consistent with the price-matching incentives created by PH.

Occasional price deviations are short-lived and typically involve only one of three to four wholesalers selling a product. When this happens, we interpret these deviations as cases where initial price postings rather than "amended" price postings are recorded. In the case of Johnnie Walker Black (1.75L), monthly wholesale prices oscillate between two price points, but for Eder, we observe only the higher of the two prices.[42] When there is dispersion in our posted wholesale prices, in nearly 80% of such cases, the cause is a single wholesaler with a higher recorded price. For this reason, in our econometric model, we assume that all firms play the iterated weak dominant strategy of matching the lower price in the second stage. Moreover, because our econometric model looks at prices and quantities at the quarterly level rather than the monthly level, we end up smoothing out some of this higher frequency price variation.

5. Econometric Model of Demand and Supply

In much of the industrial organization literature, the goal of econometric estimates of supply and demand is to estimate own- and cross-elasticities in a setting with endogenous prices, and then use first-order conditions to recover markups and marginal costs.[43] While our model of consumer

[42] For some of the months in question, we are able to confirm the dates on the submitted prices are consistent with "initial" prices. A likely explanation is that "amended" prices were submitted via fax or were not properly digitized.

[43] See for example Nevo (2001) or Backus et al. (2021a) for RTE cereal, Villas-Boas (2007) for yogurt, or Miller and Weinberg (2017) for beer.

behavior in Section 5.1 is similar to the prior literature (Miller and Weinberg, 2017; Miravete et al., 2018, 2020), our identification strategy is somewhat different.

In the typical Berry et al. (1995) setup, researchers rely on cross-market variation in prices and product assortment along with cost-shifting instruments to recover both the average price sensitivity and the heterogeneous preferences of consumers. We identify the average price sensitivity (own-elasticities) largely from our model of price-setting behavior in Section 5.2, where we combine the unique iterated weak-dominant equilibrium of the price-posting game from Section 3 with the fact that we observe both wholesaler and manufacturer prices (see Section 4). The July 2011 tax increase provides additional exogenous variation. Meanwhile, we identify the heterogeneous preferences of consumers (including the propensity to substitute within the same product category) largely from "micro-moments" formed from the NielsenIQ household panelist data (the "micro BLP" approach). We exploit both within-market variation to identify interactions between consumer demographics (income) and product characteristics, and cross-market variation to identify unobserved heterogeneity.[44]

In a sense, we are asking the demand system to do less than the usual case, but we still rely on the estimated system of demand to explain how consumers will adjust purchase patterns under counterfactual pricing where the wholesale tier has incentives to compete (rather than incentives not to compete) and where different tax instruments change the relative prices.

5.1. Demand Specification

We estimate *derived wholesale demand* using the prices and quantities at the *wholesale* level and abstract away from retailers. This allows us to capture statewide demand for spirits at bars and restaurants as well as liquor stores.[45] The main limitation of this approach is that our calculation of Marshallian "consumer surplus" combines both retailer profits (bars, restaurants, and liquor stores) and surplus to final consumers.[46]

Our model for consumer demand assumes that in each period t (quarter), a consumer i makes a discrete choice to purchase a single product j, or chooses not to make a purchase. We define a "product" as a brand-flavor-proof-size combination (e.g., *750mL of Smirnoff Flavored Vodka at 60 proof*). We standardize the purchase volume at one liter and maintain the fiction that a consumer can purchase one liter of any product (irrespective of size) at the unit (per-liter) price.[47] We do this

[44] See Berry and Haile (2024) for the non-parametric treatment and Conlon and Gortmaker (2023) for the parametric treatment.

[45] As we document in our prior work (Conlon and Rao, 2020), the retail-pricing decision at liquor stores can be complicated by nominal rigidities around prices ending in 0.99.

[46] This is more common than it may seem. For example, most studies of automobiles Berry et al. (1995, 1999) use model list prices and thus abstract of the manufacturer-dealer relationship.

[47] An alternative would have been to define the purchase unit as a single-serving (1.5 fluid ounces and a liter contains 22.5 servings) and the price as the single-serving price. This would simply change the units of prices without affecting the market shares. It would also change the interpretation of the outside option, but not the economics of the problem. Denominating everything in liters facilitates the presentation of our results under alternative tax regimes. Similar assumptions are common in the literature. For example, Nevo (2001); Backus et al. (2021a) assume

so that we can employ standard discrete choice methods while avoiding "unreasonable" counterfactual policies such as discouraging drinking by increasing the prices of large bottles and subsidizing the prices of smaller bottles. We use the legal drinking-age population estimates from the NIAAA to construct an estimate for the potential market size (more details provided in Section 4.2).

As we document in Figure 5, we rarely see price dispersion among wholesalers, but when we do we take the *minimum wholesale price*, and assume that all buyers face the same "market price." We interpret price dispersion as an error in how prices are recorded by the regulator (ie: recording unamended first-stage prices), rather than a strategic decision by the wholesaler or a price at which transactions can take place.

We assume that consumer demand follows the random coefficients nested logit model (Brenkers and Verboven, 2006; Grigolon and Verboven, 2013). This model combines the random coefficients logit with a nesting structure on the error term ε_{ijt}. The nesting structure is important because we want to allow for more substitution within a product category (Gin, Rum, Tequila, North American Whiskey, Irish/Scotch Whisky, and Vodka) than across categories.[48] The degree to which consumers substitute within the nest is governed by the parameter ρ, with $\rho = 0$ representing the plain (IIA) logit model and $\rho = 1$ representing the case where all consumers substitute within the same category.

The utility of consumer i for product j in market t is given by:

$$u_{ijt} = \beta_i \, \mathrm{x}_{jt} + \alpha_i \, p^w_{jt} + \xi_{b(j)} + \xi_t + \Delta\xi_{jt} + \varepsilon_{ijt}(\rho) \tag{12}$$

Here p^w_{jt} represents the minimum wholesale per-liter price, and x_{jt} represents additional product characteristics (bottle size, proof), and $(\xi_{b(j)}, \xi_t)$ represent brand and time fixed-effects respectively.[49] We define the individual purchase probability $s_{ijt} = \mathbb{P}(u_{ijt} > u_{ij't} \mid \alpha_i, \beta_i)$ for all $j \neq j'$. The aggregate market share is given by:[50]

$$s_{jt}(\boldsymbol{\xi_t}; \theta_1, \theta_2) = \int s_{ijt}(\alpha_{it}, \beta_{it}, \boldsymbol{\xi_t}; \theta_1, \theta_2) f(\alpha_i, \beta_i \mid y_i, \theta_2) \, h(y_i) \, \partial\alpha_i \partial\beta_i \partial y_i \tag{13}$$

We allow consumers to have heterogeneous preferences for product characteristics that are determined by observed demographics (income y_i discretized into bins $\mathcal{I}_k$) and unobserved characteristics ν_i (a vector of standard normal draws). We also require that the price coefficient α_i is lognormally distributed, so that all consumers have downward-sloping demand curves. In our main

that consumers purchase a single serving of RTE cereal at the per-serving price.

[48]We made this assumption in our original draft, and it has since been adopted in other studies of distilled spirits Miravete et al. (2018) and beer Miller and Weinberg (2017).

[49]We let $\boldsymbol{\xi_t} = [\xi_t, \xi_{b(j)}, \Delta\xi_{jt} \, \forall j]$, the stacked vector of fixed effects and demand shocks for each market t.

[50]Following Conlon and Gortmaker (2020), we partition the parameters into those that enter only demand θ_1: the parameters consumers agree on and enter the problem linearly; and those that affect both supply and demand: those which govern consumer heterogeneity and/or affect endogenous prices $\theta_2 = [\rho, \overline{\alpha}, \Sigma, \Pi]$; and those that affect only supply (and enter linearly) θ_3.

specification, we discretize income into five quintiles and allow each quintile to have a separate set of parameters so that:[51]

$$\begin{pmatrix} \ln \alpha_i \\ \beta_i \end{pmatrix} = \begin{pmatrix} \overline{\alpha} \\ \overline{\beta} \end{pmatrix} + \sum_{k=1}^{5} \Pi_k \cdot \mathbb{I}\{y_i \in \mathcal{I}_k\} + \Sigma \cdot \nu_i \tag{14}$$

There exists a vector $\boldsymbol{\xi_t}(\theta_1, \theta_2)$, which sets (13) equal to the observed shares, and allows us to construct conditional moment restrictions of the form $\mathbb{E}[\Delta\xi_{jt} \mid z_{jt}^D] = 0$ and unconditional moments $g_D(\theta_1, \theta_2) \equiv \sum_t \sum_{j \in \mathcal{J}_t} \Delta\xi_{jt}(\theta_1, \theta_2) \cdot z_{jt}^D$.

It is worth mentioning why we choose the specification above. We choose a lognormal distribution for the price coefficient α_i so that demand is guaranteed to slope downwards for all simulated consumers. This makes it feasible to compute prices and marginal costs under a wider range of alternative policies, and makes it easier to incorporate a supply side in our estimation routine (see Conlon and Gortmaker (2020, 2023) for discussion). Our specification also allows for correlation between the demand intercept β_i^0 and the price coefficient α_i through both Σ and Π. This matters because individuals can like distilled spirits (large β_i^0) while also being very price sensitive (large α_i) or vice versa. It avoids the potential scenario where the least price sensitive individuals (small α_i) purchase the majority of the spirits (either because they have a high income or because the model rules out correlation in Σ). This flexibility is particularly relevant for our counterfactuals where welfare and efficiency estimates of tax alternatives depend on whether raising taxes on specific products leads consumers to switch brands or substitute to the outside option.

We also estimate five different sets of location parameters: $(\pi_{\overline{\alpha}_{k=1}}, \pi_{\overline{\beta}_{k=1}}, \ldots, \pi_{\overline{\alpha}_{k=5}}, \pi_{\overline{\beta}_{k=5}})$, one for each "quintile bin" of the income distribution $\mathcal{I}_k$. Most papers impose a monotone relationship between income and the coefficient: e.g. Berry et al. (1995)) set $\alpha_i = \alpha \cdot \log(y_i - p_j)$, Berry et al. (1999) set $\alpha_i = \frac{\alpha}{y_i}$ and Nevo (2001) sets $\alpha_i = \alpha + \pi_0 y_i + \pi_1 y_i^2 + \sigma\nu_i$. An important feature in the market for distilled spirits is that purchases are U-shaped with respect to income, with the highest income and lowest income households purchasing the most spirits, while middle-income households tend to purchase more beer and less spirits (Conlon et al., 2024). One disadvantage of this sort of flexible "preference shifter" formulation is that we lose the ability to estimate interpretable income elasticities or construct Engel Curves.[52] However, our goal is not to understand how the market for distilled spirits would look under a different income distribution, but rather how different tax policies might impact the relative prices and consumption choices of different types of consumers.

The additional benefit of relaxing the monotonicity between (α_i, β_i^0) and income, allowing for correlation between the parameters, and imposing a lognormal distribution on α_i is that it allows a wider range of potential pass-through estimates compared to a logit with a normally distributed

[51] As a robustness test, we estimate a model that treats income y_i as continuous and estimates a single interaction for each element of α_i and β_i.

[52] An ongoing literature including Griffith et al. (2018); Miravete et al. (2023); Birchall et al. (2024) considers different ways to model the relationship between income and price sensitivity.

price coefficient (Miravete et al., 2023). Indeed, our prior regression estimates suggest that the pass-through rate is ≈ 1.3 on average (Conlon and Rao, 2020), while others have found even larger estimates for distilled spirits ≈ 1.6 (Kenkel, 2005).[53]

5.2. Specification of Supply Moments

While it is possible to estimate parameters and recover markups from the demand side alone, the original BLP papers (Berry et al., 1995, 1999) found it valuable to impose additional moments from the first-order conditions of firms. Conlon and Gortmaker (2020) demonstrated that a correctly-specified supply side provides overidentifying restrictions on the θ_2 parameters.

We have already derived an expression for the additive wholesale markups $\eta_{jt} = p^w_{jt} - mc_{jt}$ (in matrix form) in (9) and (10) for the PH game. We specify the marginal costs and solve for the unobserved cost shocks ω_{jt} as a function of the manufacturer prices p^m_{jt}, state excise taxes τ_{jt} (all measured per-liter), and other cost-shifters w_{jt}:

$$\begin{aligned} p^w_{jt} - \eta_{jt}\left(\mathcal{H}_t(\kappa), \theta_2\right) = mc_{jt} &\equiv p^m_{jt} + \tau_{jt} + \theta_3 \cdot \mathrm{w}_{jt} + \omega_{jt}. \\ \omega_{jt} &= p^w_{jt} - \eta_{jt}\left(\mathcal{H}_t(\kappa), \theta_2\right) - p^m_{jt} - \tau_{jt} - \theta_3 \cdot \mathrm{w}_{jt}. \end{aligned} \tag{15}$$

This allows us to construct an additional set of (conditional) moment restrictions $\mathbb{E}[\omega_{jt} \mid z^s_{jt}] = 0$ with sample analogue (unconditional) moments: $g_S(\theta_2, \theta_3) = \sum_t \sum_{j \in \mathcal{J}_t} \omega_{jt}(\theta_2, \theta_3) \cdot z^S_{jt}$.

In the classic BLP setup, (15) would represent a production function that linked marginal costs to product characteristics w_{jt}. In this case, the production function is Leontief in the per-liter tax τ_{jt} and manufacturer per-liter price p^m_{jt} (so that coefficients are $= 1$). The only remaining parameter to estimate is θ_3, the coefficient on w_{jt}, the additional marginal cost (per liter) incurred by the wholesaler, which might include things like labor and transportation costs. Rather than estimate θ_3, we assume that all wholesalers pay a common per-liter cost $\mathrm{w} \in \{\$0, \$0.5, \$1, \$2\}$. Higher wholesaling costs lead to slightly more elastic demand (and worse fit), so for our main specification, we assume $\mathrm{w} = 0$ and consider other values in robustness tests. Attempts at estimating θ_3 as a coefficient on either wholesaler specific constants (or a single constant) tend to lead to slightly negative values.[54] This is reassuring because Connecticut permits wholesalers to charge a (regulated) per-mile delivery charge to retailers, and it is unclear what, if any, additional marginal costs are left in w_{jt}.[55]

The main benefit of matching the observed price cost margins in the data $(p^w_{jt} - p^m_{jt} - \tau_{jt})$ as

[53] Conlon and Rao (2020) documented significant differences in pass-through rates by product size caused by \$0.99 retail price endings. Here we abstract away from retailers and unitize demand in 1L increments, but we obtain product-level own pass-through estimates between $1.29 - 1.33$.

[54] Similarly, setting $\theta_3 = 0$ and using the inequality $\mathbb{E}[\omega_{jt}] \geq 0$ leads to finding $\omega_{j,t} = 0$ for nearly all values of (j, t).

[55] Likewise, the major spirits wholesalers are located within 20 miles of New Haven so cross-wholesaler differences in delivery fees are likely negligible. See `https://law.justia.com/codes/connecticut/title-30/chapter-545/section-30-64a/` for a description of delivery charges.

close as possible to those implied by the demand model $\eta_{jt}\left(\mathcal{H}_t(\kappa), \theta_2\right)$ is that it provides additional over-identifying restrictions on the parameters in θ_2 (most importantly the price sensitivity α). This means price-cost margins and own-elasticities are targets for the model to match rather than out-of-sample predictions. This is particularly helpful because we have a small number of markets (we observe statewide wholesale shipments), and spirits are becoming more popular and more expensive over time (including after the tax hike in July 2011). Using only the demand moments and ignoring the supply moments leads to estimated demand curves that are substantially less elastic, and imply larger wholesale markups than those observed in the data.

The main drawback is that by imposing the system of first-order conditions from the PH game in (4), we cannot test them. There is a long (and growing) literature on testing conduct in differentiated-products settings (Bresnahan, 1987; Villas-Boas, 2007; Berry and Haile, 2014; Backus et al., 2021a; Duarte et al., 2021). Testing conduct amounts to detecting violations of the supply moments in (15) for different specifications of markups $\eta_{jt}\left(\mathcal{H}_t(\kappa), \theta_2\right)$. The bigger challenge here would be specifying the markups in the absence of PH, particularly when multiple wholesalers offer identical products at identical prices. This would require a more complicated demand system that predicts not only which products are purchased, but from which wholesaler (the common wholesale price observed in the PH game spares us from making this decision).

A less obvious non-issue is the "endogeneity of p^m_{jt}" or that manufacturers may choose prices p^m_{jt} with $\Delta\xi_{jt}$ (the demand shock) or ω_{jt} (the supply shock) in mind. This would only be an issue if we were trying to estimate coefficients on p^m_{jt} in (15), which we are not.[56]

5.3. Micro Moments

In addition to the moments from (aggregate) supply and demand, we augment these with moments formed from the decisions of individual panelists in the NielsenIQ data. These micro-moments (Petrin, 2002; Berry et al., 2004) are constructed by evaluating interactions of product characteristics with consumer demographics (conditional on purchase $j \neq 0$).[57] We employ the following four types of micro-moments:

$$g_M(\theta_2) = \begin{pmatrix} \mathbb{E}\left[p^w_{jt} \mid y_i \in \mathcal{I}_k, j \neq 0, t \in \mathcal{T}_{\text{year}}\right] \\ \mathbb{P}\left[y_i \in \mathcal{I}_k \mid j \neq 0, t \in \mathcal{T}_{\text{year}}\right] \\ \mathbb{P}\left[y_i \in \mathcal{I}_k \mid \mathrm{x}_j = 750\text{mL}, j \neq 0, t \in \mathcal{T}_{\text{year}}\right] \\ \mathbb{P}\left[y_i \in \mathcal{I}_k \mid \mathrm{x}_j = 1750\text{mL}, j \neq 0, t \in \mathcal{T}_{\text{year}}\right] \end{pmatrix} \tag{16}$$

[56] This is an old solution to the endogeneity problem, and the basis for the Anderson and Rubin (1949) test. Concerns about a relationship between ξ_{jt} and p^m_{jt} would suggest not including p^m_{jt} in z^D_{jt} the demand-side instruments.

[57] It is straightforward to compute the characteristics conditional on purchase ($j \neq 0$) by NielsenIQ panelists. It requires additional assumptions to determine trip frequency and potential purchase opportunities.

That is, we match the average price paid (per liter) conditional on purchase for each of the five income groups that roughly correspond to income quintiles. We also match the probability that the buyer of a generic liter of spirits or a 750mL/1750mL bottle falls into each income quintile. Each of these moments is meant to be informative about a particular parameter in Π (the interactions of consumer preferences with income quintiles). These are not necessarily the "ideal" micro-moments from Conlon and Gortmaker (2023), but we found that they can be reliably constructed from the NielsenIQ panelist data without making additional assumptions.[58]

We match a separate set of moments for each year in the panelist data from 2007-2013, in part because the set of panelists (and weights) differs by year. Variation across markets in the values of micro-moments, or variation across markets in the distribution of demographics, is generally required to separate the parameters in Π from the remaining unobserved heterogeneity in Σ (see Berry and Haile (2024); Conlon and Gortmaker (2023)). Appendix B.2 further details these micro moments.

Our final set of moments matches the probability that a consumer who makes a purchase from a particular category (Vodka, Gin, Rum, NA Whiskey, UK Whisky, Tequila) as their first choice would make a purchase from the same category as their second choice if their first choice was unavailable (but conditional on purchasing spirits). This is straightforward to construct from our demand model, and highly informative about the nesting parameter ρ:[59]

$$g_C(\theta_2) = \mathbb{P}(k \in \text{Category} \mid j \in \text{Category}, k \in \mathcal{J}_t \setminus \{j\}, j \in \mathcal{J}_t, t \in \mathcal{T}_{2007-2013}). \tag{17}$$

Unfortunately, this is not directly observed in the NielsenIQ household panelist data. We take inspiration from Atalay et al. (2023), who use repeated purchases by NielsenIQ Panelists within the same product category to assign products to nests (ie: the probability Coke and Pepsi are purchased by the same household). We ask whenever a household purchases a *different* spirits product whether that product is from the same category as the previous purchase. We also "resample" the potential ordering of purchases. This allows us to separate what might be a strong brand preference for Smirnoff (Vodka) or a large idiosyncratic ε_{ijt}, from a large value of ρ.

As an example, suppose we see a household make five purchases: Smirnoff (Vodka), Smirnoff (Vodka), Smirnoff (Vodka), Tanqueray (Gin), Absolut (Vodka). We could conclude that the same category repurchase rate is 0.5 for Smirnoff (Vodka) and 0.75 for Absolut (Vodka), so that when

[58] One issue pointed out in Conlon and Gortmaker (2023) is that micro-moments work best when they are *compatible*. In our case, we worry that the fraction of 1.75L bottles purchased by households in the Panelist dataset is significantly higher than the fraction of 1.75L bottles (by volume) in the shipment data. Thus the marginal distribution of $\mathbb{P}(\mathrm{x}_{jt} = 1.75L)$ is not the same across the two datasets, and we instead use a moment that conditions on the purchase of a bottle size, rather than the expectation $\mathbb{E}[\mathrm{x}_{jt} \cdot y_i \mid \text{ purchase }]$.

[59] See the discussion of the RCNL model in the appendix to Conlon and Gortmaker (2023).

we weight by initial purchase frequency:[60]

$$\mathbb{P}(k \in \mathcal{J}_{\text{Vodka}} \setminus \{j\} \mid j \in \mathcal{J}_{\text{Vodka}}) = \frac{1}{4} \cdot 0.75 + \frac{3}{4} \cdot 0.5 = 0.5625.$$

We construct these moments by pooling across all households and years. We estimate the repurchase rates as: Vodka (0.51), Gin (0.60), Rum (0.20), NA Whiskey (0.26), UK Whiskey (0.33), which are significantly higher than the unconditional market shares of the corresponding categories, and indicate a value of ρ that is significantly greater than zero.[61]

Finally, we need to estimate $h(y_i) = \mathbb{P}(y_i \in \mathcal{I}_k)$, the discrete distribution of household income for the state of Connecticut, which appears both in the calculation of market shares (13) and the micro-moments (16). We estimate a second distribution for $h(y_i)$ for each year. The NielsenIQ Panelist data doesn't report exact levels of household income, but rather reports it in discrete ranges. We assign income y_i into a set of more aggregated "quintile" bins $\mathcal{I}_k \in \{<$ \$25k, \$25k-\$45k, \$45k-\$70k, \$70k-\$100k, $\geq$ \$100k$\}$. Because Connecticut is a high-income state, and NielsenIQ top codes income at \$100k, 29% of households are in our top "quintile" while only 8.5% are in the bottom "quintile", even after adjusting for the NielsenIQ *projection factors*. As one might expect, household incomes decline during the Great Financial Crisis, then rise slowly over time.

We examine the possibility of including other consumer demographics in y_i. We don't see enough Black or Hispanic households purchasing spirits in Connecticut to accurately estimate micro-moments in these sub-populations. The age of the head of household doesn't seem to vary in a meaningful way with any of the product characteristics in our data, and education is highly correlated with income.[62]

5.4. Estimation Details

Estimation takes place in `PyBLP` (Conlon and Gortmaker, 2020) and uses the new micro-moment interface (Conlon and Gortmaker, 2023) — we follow the best practices described therein whenever possible.

We use all four sets of moments: demand $g_D(\theta_1, \theta_2)$; supply $g_S(\theta_2)$; micro-moments $g_M(\theta_2)$,

[60] Trivially the repurchase rate for Gin is zero.

[61] We omit the Tequila category because we don't see enough purchases by Connecticut households to estimate a repurchase rate.

[62] See Conlon et al. (2024) for an in-depth examination of the interaction between household demographics and purchases of sin goods. In the national sample, we find households over 55 are more likely to be heavy consumers of distilled spirits, though that is less evident in the Connecticut data.

and same-category purchase rates $g_C(\theta_2)$, to construct the GMM Objective function:

$$Q(\theta) = \begin{pmatrix} g_D(\theta_1, \theta_2) \\ g_S(\theta_2) \\ g_M(\theta_2) \\ g_C(\theta_2) \end{pmatrix}^T W \begin{pmatrix} g_D(\theta_1, \theta_2) \\ g_S(\theta_2) \\ g_M(\theta_2) \\ g_C(\theta_2) \end{pmatrix}. \tag{18}$$

For all specifications, we employ the second-stage optimal weighting matrix $\widehat{W}(\widehat{\theta})$ and the Chamberlain (1987) approximation to the optimal instruments: $\mathbb{E}\left[\frac{\partial \xi_{jt}}{\partial \theta} \mid z_{jt}, \widehat{\theta}\right]$ for demand, and $\mathbb{E}\left[\frac{\partial \omega_{jt}}{\partial \theta} \mid z_{jt}, \widehat{\theta}\right]$ for supply. When constructing the weighting matrix, we allow for correlation between the blocks of supply and demand moments: $g_D(\theta), g_S(\theta)$ but impose independence from other blocks. For the $g_M(\theta_2)$ micro-moments, we treat each year of the NielsenIQ panelist data as an independent survey dataset but allow for correlation between the moments within the same year.[63]

In order to obtain a first-stage pilot estimate for $\widehat{\theta}$ so that we can construct the weighting matrix and approximation to the optimal instruments, we need to choose initial instruments (z^d_{jt}, z^s_{jt}). For the supply instruments we set $z^s_{jt} = [1, p^m_{jt}, \tau_{jt}]$ using only the included regressors from (15) as instruments. We experimented with using higher-order functions of p^m_{jt} to approximate the conditional moment restriction but found it did not matter in practice.

For the demand side, we need to choose instruments z^d_{jt}. The obvious instruments are the excluded cost variables from (15): p^m_{jt} (the manufacturer price); and τ_{jt} (the per-liter excise tax, which increased in July 2011). In addition, we follow the recipe in Gandhi and Houde (2019) and construct instruments based on quadratic interactions of differences in exogenous product characteristics (category, size, proof, flavored) $\sum_k (\mathrm{x}_{jt} - \mathrm{x}_{kt})^2$. Because this tends to produce instruments that are highly correlated with one another, we take the first 32 principal components and use those as z_{jt}. In words, these instruments convey, "How many other 750mL flavored vodkas are available?" or "How many other similar proof whiskeys are for sale?" These are meant to capture the "crowding" of the product space over time.[64] An important characteristic not typically in x_{jt}, but available in our study, is the manufacturer (upstream) price p^m_{jt}. This allows us to ask: "How many other 750mL vodkas with similar upstream prices are available?"

In order to compute the integral in (13), we must determine a way to approximate the joint distribution of income and unobserved heterogeneity $h(y_{it}, \nu_{it})$. Our initial estimates use 500 draws from the discrete distribution of income and the three-dimensional (log) normal distribution of unobserved heterogeneity. When the dimension of integration is two or less, we use a product rule of the Gauss-Hermite quadrature rule and the discrete distribution on income y_{it}. The goal

[63]See Conlon and Gortmaker (2023) for precise details about how the standard errors and weighting matrix are adjusted.

[64]In the data, we see more U.S. whiskey products entering and fewer flavored-rum products.

of estimation is to recover the Cholesky root L such that $LL' = \Sigma$.[65] For some specifications, elements of L are zero so that Σ is no longer full rank. In such cases, we reduce both the dimension of integration and restrict L so that we obtain correct inference (avoiding the problems associated with parameters on the boundary).

5.5. Parameter Estimates

We report our estimated parameters for our main specification in Table 3. The parameters themselves are not easily interpretable, though we can see some obvious patterns. The demographic interactions in Π correspond directly to the micro-moments in $g_M(\theta_2)$.

At higher income levels, consumers become less price sensitive (as one might expect), but also the intercept for all spirits demand declines. This is important as it implies that higher-income consumers don't purchase all of the alcohol, but instead purchase similar quantities at higher prices. (Because the price sensitivity parameters are log-normal, a larger negative number indicates *less price sensitivity* so that $\alpha_i = -e^{-0.736} = -0.479$ for the lowest income group and $\alpha_i = -e^{-2.291} = -0.101$ for the highest income group.) We see less of a discernible pattern for the large format size, 1750mL. Our fixed effects are at the brand level (e.g., *Smirnoff Vodka 80-Proof*), so different sizes share the same ξ_j term, but may differ in the 1750mL dummy. The omitted middle-income group \$45k-\$75k exhibits a slight preference for large bottles $\beta_i^{1750} = 0.30$, while the highest and lowest income groups exhibit a slight preference ($\beta_i^{1750} < 0$) for smaller (750mL and 1L) bottles.

Larger values of the nesting parameter ρ imply a higher probability that a consumer's second-choice product will be in the same category as their first-choice product. At the estimated value of $\rho = 0.27$, this means that 73% of vodka buyers would switch to another vodka. For the other categories, the model predicts: Gin (45%), Rum (56%), NA Whiskey (53%), UK Whisky (46%). Overall, these are slightly higher than target moments $g_C(\theta_2)$ with the exception of the Gin category (which is 15 percentage points lower).

We also report the estimated unobserved preference parameters as the variance-covariance matrix Σ. Even after controlling for demographics, there is substantial unobserved heterogeneity in price-sensitivity α_i and the overall intercept for spirits demand β_i^0. However, much like in the case of the Π parameters, we estimate a strong correlation between those who like alcohol but dislike price, and those who are less price sensitive but like alcohol less. This is likely driven in part by the large quantity of sales concentrated at relatively low price points.

More informative than the parameter estimates are the predicted elasticities and economic objects of the equilibrium model. The model does an excellent job of matching the predicted markups. This should not be a surprise because they are the targeted moments in $g_S(\theta_2)$. On average, observed Lerner markups match predicted Lerner markups of $\frac{P-MC}{P} = 0.23$. The observed

[65] These are consistent with the "best practices" for `PyBLP` in Conlon and Gortmaker (2020).

IQR is slightly more dispersed $(0.188, 0.276)$ compared to the model-predicted IQR of $(0.222, 0.255)$. Part of this is the shrinkage provided by the parametric model, and part is that while we can match quarterly markups on average, we don't have features in the model (specifically the instrument set) to match higher frequency price variation found in Figure 5.[66]

Directly related to the markups are the own-price elasticities. In Table 3 we report a median own-elasticity of -4.77 and an IQR of $(-5.07, -4.48)$. Without the moments matching the markups $g_S(\theta_2)$, we would estimate significantly *less elastic* demand curves, while increasing the wholesaling marginal cost w_{jt} would produce *more elastic* demand curves.

We also report product-level own-price elasticities in Figure 6 as a function of price for the final period in our data. Under the plain logit, we would expect to find that own-elasticities are increasing in prices $\epsilon_{jj} = -\alpha p_j \cdot (1 - s_j)$. Instead, we find an inverted U-shape where the least expensive products have the most elastic demands, and products priced around \$32/L have the least elastic demands.

Understanding the welfare implications of different tax policies, most importantly, requires measuring whether consumers respond to higher prices by switching brands or by substituting away from spirits altogether. There are two ways to measure this. The first is the aggregate elasticity, or how overall spirits demand would respond to a 1% tax on all distilled spirits. We estimate that demand would fall around -0.53% for each 1% price increase. The other way to measure substitution to the outside good is via the diversion ratio. This asks, conditional on leaving a product in response to the price change, what fraction of consumers switch to the no-purchase option? We estimate diversion ratios with an IQR between $D_{j0} \in (0.40, 0.47)$, but with significant dispersion. An important finding in Figure 6 is that products priced around \$20/L tend to have lower diversion ratios, while the least expensive products can have diversion ratios of 0.55 or greater. (Less important is the slightly higher diversion ratios for seldom purchased super-premium products such as \$50/L single-malt Scotch whisky). This matters because increasing the prices of less-expensive products ($< \$10/L$) will lead to a larger reduction in spirits consumption than raising the prices of moderately priced \$25/L products

Compared to some recent IO approaches that estimated demand for distilled spirits in Pennsylvania (Miravete et al., 2020, 2018), our estimates suggest somewhat larger own-price elasticities (-4.77 vs. -3.75), but much less elastic aggregate elasticities (-0.53 vs. -2.48), which implies *greater substitution between brands* and much *lower diversion to the outside good*.[67] Regression estimates of the aggregate elasticity for spirits vary considerably (both in credibility and point estimates). On the lower end Wagenaar et al. (2009) report an elasticity of -0.29 as a result of their meta-analysis, while on the higher end Leung and Phelps (1993) report an elasticity of -1.5.

[66] It is worth noting that Figure 5 reports monthly prices while our demand model is estimated using (smoother) quarterly prices and quantities.

[67] If we did not try to match the level of markups, we would estimate smaller own-price elasticities. Increasing the wholesaling cost w_{jt} leads to smaller markups and even *more elastic* demand.

Perhaps the best way to validate our demand model is to examine the predicted substitution patterns. For several top products, we compute the diversion ratio from that product to its closest substitutes and report both the name and diversion ratios in Table 4. For the most part, products appear to compete with similarly-priced products within the same category (largely due to the nesting parameter ρ). For example, Dubra Vodka (1.75L), the least expensive product in our sample, appears to compete most closely with the other discount vodka brands (Popov, Sobieski, Gray's Peak, and Bellows) as well as Smirnoff vodka (a mid-range vodka and the best selling product overall). Belvedere (a super premium vodka) appears to compete with Grey Goose, Absolut, and Ketel One. Woodford Reserve, a premium bourbon, competes primarily with Maker's Mark and Jack Daniels, the two best-selling American whiskeys. Because of the nesting structure, we see that Captain Morgan's competes primarily with Bacardi Rum, and Beefeater Gin competes largely with other gins (as well as Smirnoff vodka). We also see that consumers largely substitute from 1.75L bottles to 1.75L bottles; or 750mL and 1L bottles to 750mL and 1L bottles.

5.6. Alternative Parameter Estimates and Identification

Technically speaking, in nonlinear GMM, all moments identify all parameters. The parameters governing demographic interactions Π generally correspond to the "demographic interaction micro-moments" $g_M(\theta_2)$ described in detail in Section 5.3 and Appendix B.2, and the average price sensitivity α is pinned down primarily by the supply moments $g_S(\theta_2)$ in (15). To test the robustness of our estimates to the specification of marginal cost, we re-estimate the model assuming that wholesalers incur a per-liter cost $\mathrm{w}_{jt} = 1$ instead of 0 in Appendix C.2, which leads to smaller markups and more elastic demand estimates.

The more difficult to estimate parameters are the covariance matrix of the unobserved heterogeneity Σ and the nesting parameter ρ. Following the arguments in Berry and Haile (2024), one can estimate Σ with both cross-market (year) variation in the micro-moments themselves $g_M(\theta_2)$, or cross-market variation in product assortment (and prices).

In Appendix C.2, we illustrate how the predictions of the model vary with the nesting parameter ρ. This tends to be an important and difficult to estimate parameter. Typically one relies on cross-market variation in the availability of products within each category in order to estimate ρ. Instead, we rely primarily on the probability of "repeat purchases" within the same category or "pseudo second-choice moments" $g_C(\theta_2)$, with more substitution from Vodka $\to$ Vodka indicating a larger value of ρ. In Table C.1, we find that larger values of ρ imply larger own-elasticities, less diversion to the outside option, and a smaller overall elasticity to a 1% tax on spirits. We also illustrate how our second-choice moments "select" a value of ρ.

We have also estimated a variety of restricted versions of the specification in Table 3. Excluding the Π or Σ parameters significantly worsens the overall fit of the estimates. Eliminating the nesting parameter ρ leads to predictably nonsensical (logit-like) substitution patterns. Additional parameters in Σ, such as variance-covariance terms for the 1750mL dummy, are difficult to separate from the variance-covariance term on the constant and do not significantly improve the overall fit.

6. Welfare Under Counterfactual Policies

The primary argument in favor of policies like PH is that it restricts ethanol consumption by reducing competitive incentives among wholesalers. A secondary rationale is that by eliminating wholesale price discrimination (à la Robinson-Patman), PH redirects surplus from large to small retailers, though in Appendix Table D.3, we find that states which terminate PH see growth in both the number of retail (liquor) stores and retail (liquor) employment. Therefore we focus our welfare analysis on how effective PH is at reducing alcohol consumption as measured by forgone tax revenues and lost consumer surplus.

The starting point for our welfare analysis is that in the absence of PH, the wholesale tier would become perfectly competitive. One reason to use perfect competition as a benchmark is that we frequently observe multiple wholesalers distributing identical products (e.g. see *Johnnie Walker Black, 1.75L* in Figure 5). Unlike beer distribution, the market for distilled spirits in Connecticut does not have *franchise laws* which restrict wholesalers to *exclusive territories*, and all wholesalers service the entire state.[68] The second reason is that in order to quantify the welfare consequences of using market power (rather than taxation) to limit ethanol consumption, zero market power provides an obvious comparison.

We describe several simple tax instruments that we consider as alternatives to the PH system in Table 5: (a) a volumetric tax (similar to the one that Connecticut and most license states use currently); (b) an ethanol specific tax (similar to the one used by the federal government); (c) an *ad-valorem* tax (similar to the general sales tax or the fixed-markup rule used in control states like Pennsylvania (Miravete et al., 2018)); (d) a price floor per unit of ethanol (similar to that enacted in Scotland and examined by Griffith et al. (2022)). We also provide some benchmarks to illustrate the full range of potential policies: (e) the perfectly competitive price absent any taxes; (f) a profit-maximizing multi-product monopolist (similar to the privatized monopoly of Maine); and (g) a product-specific (Ramsey) tax that maximizes consumer surplus subject to either a revenue or aggregate ethanol constraint. Under each of our policy alternatives, we do not change the baseline federal excise tax (paid by manufacturers), which we include in the manufacturer price p^m_{jt}, but replace the existing state volumetric tax $\tau_{jt} = \$1.42/L$ with the policy alternative. In our baseline scenario, we assume that wholesalers incur no additional marginal costs ($\mathrm{w}_{jt} = 0$). Later, we allow for a \$1 per liter wholesaling cost ($\mathrm{w}_{jt} = 1$), and consider a variety of alternative costs in

[68] See Asker (2016) for exclusivity in beer distribution. In Connecticut, all of the major spirits wholesalers are located near one another in the center of the state. While Bertrand competition among two firms might result in marginal cost pricing, some products are sold by a single wholesaler. In a world without PH, the manufacturer could eliminate double marginalization by selling through a second wholesaler. Alternatively, wholesale markups might be eliminated if manufacturers directly supplied retailers rather than using wholesalers as intermediaries.

Appendix C.2.

$$mc_{jt} = p_{jt}^m + \underbrace{\tau_{jt}}_{=0} + \underbrace{\mathrm{w}_{jt}}_{\in\{0,\frac{1}{2},1,\ldots\}} \tag{19}$$

Our baseline scenario also holds the upstream price p_{jt}^m fixed, though later, we provide additional results that allow manufacturers to re-optimize (increase) prices after the wholesaler markup is eliminated. We view these as upper and lower bounds on how manufacturers might respond. The main constraint on manufacturer price adjustment is likely that they sell the same products in neighboring states (New York, New Jersey, Connecticut, and Rhode Island) and may be limited in their ability to price discriminate.

Because our demand estimates reflect derived demand at the *wholesale level* and abstract away from retail pricing, the area under the demand curve corresponds to the joint welfare of both retailers (bars, restaurants, and liquor stores) as well as households. The advantage is that we consider the entire market for spirits (both on- and off-premise), but the disadvantage is that we cannot separate the surplus of final consumers from small and large retailers. We compute both the aggregate impact and the impact on each of the five income "quintiles" described in Section 5.3.

The primary motivation for limiting the consumption of distilled spirits is the associated negative externalities. There is little agreement on the magnitude of the externality.[69] Because our analysis focuses largely on the wholesale tier, we are limited in our ability to model *who* does the drinking. Instead, we treat the externality as if it were *atmospheric* (i.e., it depends on only the aggregate level of ethanol consumption). This would be problematic if we were concerned that there were larger negative externalities associated with drinking tequila rather than vodka, or that lost productivity was greater for households earning over \$100K.[70] Rather than take a stand on the externality, we consider three policy targets: (a) keeping ethanol consumption fixed at the existing level under PH; (b) increasing ethanol consumption by 10%; (c) reducing ethanol consumption by 10%. In our final exercise, we ask: How much can we reduce ethanol consumption without reducing consumer surplus?

6.1. Comparing Tax Instruments

Our first goal is to understand how the different tax instruments affect the relative prices of products. To do this, we eliminate the wholesaler markup and the existing volumetric tax and then find the level of each tax instrument that holds overall ethanol consumption fixed at the PH level. We then examine how the counterfactual prices compare to those observed under the PH system

[69]See `https://www.ias.org.uk/wp-content/uploads/2020/12/The-costs-of-alcohol-to-society.pdf` and `https://www.ncbi.nlm.nih.gov/pmc/articles/PMC8200347`

[70]One serious concern is that the heaviest drinkers account for the bulk of the external damage (Griffith et al., 2019). Conlon et al. (2024) find that in the U.S. the heaviest drinkers are concentrated among the highest and lowest income groups.

in Figure 7.

Product prices that lie below the black 45-degree line become less expensive under the alternative policy than under PH, while prices above the line become more expensive under the alternative policy. Many of the alternative policies achieve the same level of ethanol consumption but are "flatter" than the 45-degree line in Figure 7, so that the most expensive products become "cheaper" while the least expensive products become more expensive when compared to PH. Products with the lowest prices tend to feature the largest own-elasticities and the most substitution to the outside option (Figure 6), making these products highly efficient targets for reducing ethanol consumption. "Flatter" curves generate higher consumer surplus by increasing prices on the least expensive products while allowing consumers to substitute towards premium products as they become less costly.

Figure 7 displays several notable patterns. First, the minimum unit price amounts to setting a price floor while otherwise pricing at marginal cost: $p_{jt}^{w} = \min\left\{\$18.90 \cdot \frac{Proof_j}{80}, p_{jt}^{m}\right\}$. Product-specific (Ramsey) prices that maximize consumer surplus subject to an ethanol constraint yield nearly identical prices $p_{jt}^{w} = mc_{jt}$ for products above the "price floor," but below the floor incorporate marginal cost and elasticity information for some additional "slope."

Second, there is little difference between taxing volume and taxing ethanol content, since the bulk of products are around 80-proof (40% alcohol by volume). These taxes effectively add a fixed $\tau = \$5.52$ (per liter) or $\tau = \$13.70$ (per liter of ethanol) to each product, which is "flatter" than the 45-degree line.[71]

Third, sales taxes lead to an even "steeper" relationship than PH. In part this stems from the fact that the marginal costs (manufacturer prices p_{jt}^{m}) at the low end of the distribution are quite low – and raising those prices sufficiently requires very high sales tax rates (72% without existing excise taxes, and 41% if we don't eliminate existing excise taxes), which exceed the typical markups under PH (around 23%), especially among high-end products.[72] Product-specific (Ramsey) taxes, which maximize consumer surplus subject to a revenue constraint, look similar to the uniform sales taxes in the middle of the range, but have higher prices than PH for the least expensive products, and lower prices than PH for the most expensive products (producing a slight "S-shape").

6.2. Welfare Results

We compare PH and the alternative tax policies across our three welfare measures: (a) consumer surplus; (b) revenue raised; and (c) overall ethanol consumption (external damage). In Figure 8, we map out the welfare tradeoffs for all possible levels of each tax instrument and report the percentage

[71] A combined tax rate of \$8.37/L may seem high compared to the existing state tax of \$1.56/L (and federal tax of \$2.85/L). To put things in perspective, taxes on spirits in the UK are roughly twice as large at £12.65/L (or \$16.35/L) at 40% ABV.

[72] This in line with (slightly smaller) than the Pennsylvania state-run monopoly studied in Miravete et al. (2018, 2020) which charges a \$2 per bottle fee and 30% markup with an 18% sales tax for a combined markup of $p_{jt} = 1.53 \cdot (p_{jt}^{m} + 2.00)$

changes in welfare measures relative to the status quo policy (PH), which we locate at the origin of the graphs in Figure 8. For each tax instrument, we denote the point on the curve that: leaves ethanol consumption unchanged ($*$), increases ethanol consumption by 10% ($+$), and decreases ethanol consumption by 10% ($\times$).

While it is unlikely to be the preferred policy of lawmakers if we eliminated PH and existing volumetric taxes, ethanol consumption would rise by 126%, and consumer surplus would rise by 110%. We denote this point by ($P = MC$). If we maintained the existing volumetric taxes, ethanol consumption would rise by 84% and consumer surplus by 76%, and tax revenue would rise by 83% (from additional sales). While this would represent a dramatic increase, the predicted per-capita spirits sales would be similar to Delaware or Washington, DC (and lower than New Hampshire).

The left panel of Figure 8 considers the trade-off between overall ethanol consumption (the source of the negative externality) and consumer surplus. Here, the frontier is defined by Ramsey (Ethanol), which maximizes consumer surplus at each level of ethanol consumption by setting product-specific taxes (and ignoring tax revenue). As was the case in Figure 7, the minimum ethanol unit price is remarkably close to the frontier. The existing PH system is dominated by simple taxes on volume or ethanol content, which allow for higher levels of consumer surplus at each level of ethanol consumption. However, in this respect, the PH system performs better than a uniform sales tax rate. Under a uniform sales tax, raising prices at the low end of the distribution enough to discourage consumption requires extremely high sales-tax rates, leading to even higher prices at the high end of the distribution (a "steeper" curve in Figure 7). One advantage of the PH system is that profit-maximizing wholesalers are able to choose different markups for different products depending on their elasticities, rather than being constrained to a single tax rate.

The frontier in the right panel of Figure 8 is defined by the Ramsey (Revenue) scenario, which uses product-specific taxes to maximize consumer surplus at each level of tax revenue (while ignoring ethanol consumption). This traces out a curve from the perfectly competitive price (with no additional taxes) to the monopoly price, which achieves the highest possible revenue increase of 345% (but reduces consumer surplus by 16.9% and ethanol consumption by 10.2%). The uniform sales tax gets surprisingly close to this frontier, though it requires significantly higher levels of ethanol consumption (around 10%) to achieve similar levels of revenue and consumer surplus as the Ramsey frontier. As in Figure 7, taxing volume or taxing ethanol content yields nearly identical results, but would be less effective at raising revenue than sales taxes, and are thus inside the frontier. An obvious limitation of PH is that differences between wholesale prices and marginal costs are captured as wholesaler profits rather than tax revenue. Indeed, under PH, the only source of tax revenue is the \$1.42/L volumetric tax. However, even if we could extract wholesaler profits via a lump-sum tax, not only is this point (denoted by ($PH + PS$)) dominated by volumetric/ethanol taxes, but the corresponding taxes would actually reduce ethanol consumption by more than 10%. The highly similar product-specific Ramsey (Ethanol) taxes and the minimum-unit price are both less effective at raising tax revenue than $(PH + PS)$, but still raise more revenue than the existing PH system.[73]

6.3. Distributional Analysis and Endogenous Responses

The main takeaway from Figures 7 and 8 is that PH is dominated by simple tax instruments such as volumetric or ethanol taxes, which produce greater consumer surplus and tax revenue at lower levels of ethanol consumption. However, those alternative policies tend to produce "flatter" relationships which increase prices at the low end and reduce prices at the high end of the market. This raises potential distributional concerns, particularly since the micro-moments suggest that the least expensive products are purchased disproportionately by the lowest-income households.[74]

In Table 6, we decompose the percentage change in consumer surplus in Figure 8 for each of our five income bins. We report this for our three scenarios: (a) holding ethanol fixed at the PH level; (b) increasing ethanol consumption by 10%; (c) reducing ethanol consumption by 10%. Though we report the effects for all of the alternative tax policies, we focus our attention primarily on the volumetric and ethanol taxes. Even under a 10% reduction in overall ethanol consumption, the volumetric and ethanol taxes increase overall consumer surplus relative to PH. However, all of the gains to consumer surplus are captured by the highest income (> $100k) group (+10.2% under ethanol taxes and +9.7% under volumetric taxes), which accounts for roughly 30% of the population of Connecticut. Meanwhile, other income groups are actually worse off. We see a similar pattern if we hold ethanol fixed at existing levels, where the majority of the gains accrue to the highest income group. Under an ethanol tax, all groups are slightly better off, while under a volumetric tax, households earning below $70,000 in income are slightly worse off.

Our welfare analysis has considered a wide range of tax rates and instruments, but thus far, we have assumed that in the absence of PH, the wholesale tier would be perfectly competitive. We focus on an ethanol tax for the remainder because it performs the best in Table 6, is already implemented by the federal government, and most directly addresses the externality associated with alcohol consumption. In Table 7, we relax perfect competition in two ways: (a) we allow for uniform w_{jt} = $1 per-liter marginal cost incurred by wholesalers; (b) we allow for manufacturers to adjust prices after the wholesale markups have been eliminated.[75] The first panel describes an ethanol tax that leaves total ethanol consumption unchanged from PH (as in the top panel of Table 6). In

[73] We (generously) assume that under the minimum-unit price, the state collects the difference between the marginal cost and the minimum unit price as revenue. In practice, collecting revenue from a minimum-unit price or a lump-sum tax on wholesalers could prove challenging, and these should be thought of as a theoretical benchmark. One approach might be to set a sufficiently large license fee for wholesalers or to auction off wholesale licenses. Assessing a tax based on the difference between the manufacturer price and some "minimum unit price" might be possible (but could likely be undone if manufacturers raised prices).

[74] The distributional analysis is complicated by the fact that our measures of consumer welfare implicitly include retailer surplus because we model demand at the wholesale level. As such, any surplus losses and gains likely partly accrue to retail establishment owners.

[75] We provide a full welfare analysis with a wholesaling cost of $1/L in Appendix C.2.2.

the second panel, we see how much we can reduce ethanol consumption (and associated negative externalities) without reducing consumer surplus in aggregate.

The main finding from Table 7 is that under an ethanol tax, it is possible to reduce ethanol consumption from spirits by 12.87% while increasing tax revenue by 293% while maintaining the PH level of overall consumer surplus. Allowing for an additional w_{jt} = \$1/L marginal cost for wholesalers does not change the economics of the problem and simply reduces the tax rate from \$6.50/L to \$5.47/L (and the corresponding revenue by almost exactly \$1/L). Allowing upstream manufacturers to raise their prices significantly increases their estimated profits (an increase of 29% compared to an increase of 9%), but still allows for a nearly 12% reduction in ethanol consumption without reducing (aggregate) consumer surplus — again, this functions largely as a transfer from tax revenue to manufacturers.[76]

Middle-income households (between \$45,000−\$75,000) are nearly indifferent between an ethanol tax that holds aggregate ethanol consumption fixed at the PH level and the existing PH system. These households tend to prefer beer and have the lowest per capita spirits consumption (see Conlon et al. (2024)). They also serve as a constraint on policymakers, as any policy that reduces ethanol consumption relative to PH is likely to reduce the consumer surplus of this group (or the households earning less than \$25,000).

One approach to addressing the distributional effects of tax alternatives to PH might be to transfer some of the additional tax revenue in order to hold harmless the lowest-income groups (such as by reducing taxes on wage income or expanding the EITC) while still reducing the overall level of ethanol consumption in Connecticut. However, such transfers may be complicated by political considerations. An additional complication is that demand for spirits is not spread uniformly across households within an income group (not all households purchase spirits), so that true "Pareto Improvements" may not be feasible (it certainly will not be feasible for households with a high idiosyncratic preference ε_{ijt} for *Dubra Vodka* which sells for less than \$8/L).

A deeper question is whether lower levels of consumer surplus which arise from reduced consumption of spirits (rather than consumption of less preferred products) should be treated as a welfare loss. In the literature on sugar-sweetened beverage (SSB) taxes and "internalities," the main motivation for SSB taxes is to reduce consumption by low-income households (see Allcott et al. (2019)). Similarly, if we think that the heaviest drinkers or those who generate the most internal/external damage are more likely to seek out the least expensive forms of ethanol, then our alternative policies *understate* the reduction in external damage for a given level of aggregate ethanol consumption. A key limitation is that our top-line number represents a 12.87% reduction in *ethanol from spirits*, but some of these spirits buyers may switch to beer or wine instead of away from alcoholic beverages entirely.

[76] Allowing manufacturers to re-optimize prices (against elasticities) also leads to larger increases on high-end/premium products so that the welfare gains are less concentrated among the wealthiest households.

6.4. Discussion: Why does PH perform so poorly?

In theory, one might have expected the post-and-hold system to perform better. Firms with market power have the ability to choose prices more flexibly than a single tax rate would allow. Moreover, they can (and do) choose prices with knowledge of own- and cross-price elasticities. Indeed, it has been known since Ramsey (1927) that there is a duality between the optimal tax problem and the multi-product monopoly problem, and that the monopolist minimizes deadweight loss for a particular level of revenue. This raises the question, how does the PH problem solved by wholesale firms differ from the social planner's problem?

In Appendix A.3, we solve the constrained optimization problem of a social planner who chooses prices to maximize social surplus subject to a minimum required revenue (with Lagrange multiplier λ_r) and a maximum value of ethanol consumption (with Lagrange multiplier λ_e). To simplify things, we assume the externality is atmospheric with the ethanol content of each product given by e_j. This produces the following FOC:

$$p_j = \frac{1}{1-\theta/|\epsilon_{jj}|}\left[mc_j + \frac{\lambda_e}{1+\lambda_r}e_j + \sum_{k\neq j} D_{jk}\left(p_k - mc_k - \frac{\lambda_e}{1+\lambda_r}e_k\right)\right]. \tag{20}$$

The first term functions like an inverse elasticity markup rule, where $\theta = \frac{\lambda_r}{1+\lambda_r}$ behaves like a conduct parameter with $\theta = 0$ corresponding to the perfectly competitive solution and $\theta = 1$ corresponding to the monopoly solution. We compare this to the solution to the PH problem from (7):

$$p_j = \frac{1}{1-1/|\epsilon_{jj}|}\cdot\left[mc_j + \sum_{k\in\mathcal{J}_f\setminus\{j\}} \kappa_{jk}\cdot D_{jk}\cdot(p_k - mc_k)\right].$$

The main difference is that the PH first-order conditions effectively set $\lambda_e = 0$ and $\lambda_r \to \infty$ as in the monopoly problem. An additional wedge arises because the *opportunity cost* (shown in brackets) depends on the term $\kappa_{jk} = \gamma_k^f/\gamma_j^f$, which measures the relative market shares of k and j for the pivotal seller of j. The Ramsey solution would set $\kappa_{jk} = 1$ for all (j,k), whereas the PH solution will set $\gamma_k^f = 0$ for products not distributed by the pivotal seller of j, and may set $\gamma_k^f/\gamma_j^f \lesseqgtr 1$ for others. In practice, the former tends to dominate, so that the PH solution tends to understate the effective diversion ratios $\kappa_{jk}\cdot D_{jk}$ instead of D_{jk}.[77] This is particularly true for premium products, for which diversion to other brands is larger (because diversion to the outside good D_{j0} is smaller, as in Figure 6). The result is that PH applies a larger markup ($\theta = 1$ or $\lambda_r \to \infty$) on a smaller

[77]Because not all wholesalers distribute all products $\mathcal{J}_f \subset \mathcal{J}$.

marginal cost than the planner's, which distorts not only the price levels, but the relative prices as well. An important feature in distilled spirits is the high degree of "quality dispersion" where prices or price-cost margins ($p_k - mc_k$) range from less than \$10/L to more than \$50/L, even though the products contain similar amounts of ethanol (and likely generate similar amounts of external damage). This pushes the last term in brackets from (20) upwards, particularly for the most expensive products, so that we understate the *planner's opportunity cost* by less.

Applying a constant proportional markup (such as a uniform sales tax) would imply that additive (dollar) markups could be more than 5× higher on the most expensive products. From a perspective of purely corrective taxation, this does not make much sense, even though it is more "progressive" than PH or taxes on volume or on ethanol. Markups under PH tend not to be quite so "steep", but as demonstrated in Figures 4 and 7, the PH system still produces much higher (additive) markups in dollars on more expensive products.[78] Indeed, Figure 6 shows that own-elasticities tend to be U-shaped in prices (and corresponding Lerner markups tend to be inverse U-shaped). By getting *relative prices* wrong, PH leads to a lower level of *total surplus* than the corresponding volumetric or ethanol tax.[79]

7. Conclusion

We show that the post-and-hold system employed by Connecticut is not effective at discouraging the consumption of ethanol or raising tax revenues when compared to simple, commonly used tax instruments. Indeed, it is possible to reduce overall ethanol consumption (and associated externalities) by more than 12.87% without reducing consumer surplus, and while increasing tax revenues by nearly 300% (or around \$180 million per year).

Our results shed additional light on previous studies of alcoholic beverages because we are able to trace out a wide range of policy instruments over a variety of different values. As an example, we show that the minimum ethanol unit price adopted by Scotland (and analyzed by Griffith et al. (2022)) is very similar to the solution of a social planner who wishes to maximize consumer surplus subject to an upper bound on aggregate ethanol consumption. While this policy is effective at limiting consumption, it is ineffective at raising tax revenues, which perhaps explains why it has not been more widely adopted. Likewise, we show that a uniform sales tax rate does a relatively good job approximating the problem of a social planner who maximizes consumer surplus subject to a revenue constraint. However, while the uniform sales tax is able to generate similar levels of consumer surplus and tax revenue as the "Ramsey" planner, it does so at significantly higher levels of ethanol consumption (and hence negative externalities). This helps to reconcile our results with prior studies of uniform markup rules (which operate like sales or *ad valorem* taxes) set by the state-run monopolist in Pennsylvania in Miravete et al. (2018, 2020).

[78] As noted in Table 3, the middle 50% of observed Lerner markups are between 18-28%.

[79] Ethanol taxes can also be written as a solution to (20) by setting $\lambda_r = \theta = 0$ which gives a markup across products based only on ABV: $\lambda_e \cdot e_j$ but ignoring the final term in brackets.

Our findings are driven by our unusually complete data. Our ability to combine wholesaler prices with upstream (manufacturer/distiller) input prices allows us to measure the wholesale markups of profit-maximizing firms, showing that they generally increase with input price (see Figure 4). Matching these markups — along with micro-moments that reveal lower-income consumers generally pay lower prices but tend to consume somewhat less rather than more alcohol than high-income consumers[80] — yields demand estimates that directly inform our counterfactual policies. Our estimates indicate that the least expensive products tend to have more elastic demand and are more substitutable to the outside option (see Figure 6). By raising the prices of these products, and reducing the prices of premium products, we are able to undo the distortion in relative prices caused by the PH system, increase consumer surplus, and decrease ethanol consumption.

The seemingly "free lunch" arises because firms with market power may face substantially different incentives than a social planner. When products are differentiated, relying on firms with market power to provide "second-best" regulation of externalities may be far from optimal. In our context, consumers care about product quality, and firms with market power set the effective "tax" on product quality too high and the effective "tax" on externalities too low, significantly distorting the choices of infra-marginal consumers. The idea that all policies that reduce consumption of sin goods are equally good is simply untrue, and any market design should address the dual objectives of policymakers as well as the preferences of consumers.

These results should serve as a cautionary tale to policymakers who wish to outsource the mitigation of negative externalities to private firms. They can also be applied to the broader context beyond distilled spirits. As states have legalized other sin goods such as marijuana, they have limited competition by placing significant restrictions on entry (Thomas, 2019; Hollenbeck et al., 2004) — or levied *ad valorem* taxes at different parts of the supply chain (Hansen et al., 2022) that may not perform as well as Pigouvian taxes (Hansen et al., 2020) in addressing negative externalities while generating tax revenue. Restricting competition, particularly when products are differentiated, may not perform as well as policymakers hope.

[80]We confirm this pattern in our other work (Conlon et al., 2024)

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Table 1: Summary Statistics: Wholesale and Manufacturer Price Connecticut Q3 2007 - Q2 2013

	# Obs	Share	Proof	% Flavored	Manufacturer Price	Manufacturer Margin	Wholesaler Price	Wholesaler Margin	Retailer Price	Retailer Margin
Gin	59	7.40	87.07	0.02	11.15	3.01	16.21	3.79	18.72	2.34
Rum	147	17.50	73.63	0.21	10.17	2.60	15.08	3.65	17.60	2.52
Tequila	92	4.90	80.04	0.00	15.17	4.07	22.05	5.60	28.51	4.70
Vodka	208	44.80	79.19	0.15	10.73	2.79	15.42	3.42	18.05	2.54
NA Whiskey	127	15.20	81.80	0.00	11.59	3.18	17.41	4.54	20.08	2.76
UK Whiskey	102	10.20	80.79	0.00	18.36	4.51	25.04	5.41	28.15	3.12
750mL	310	20.10	79.05	0.18	16.44	4.32	23.57	5.85	28.32	4.74
1L	174	23.20	79.32	0.12	13.80	3.73	19.92	4.85	24.85	4.35
1.75L	251	56.70	79.55	0.08	9.32	2.36	13.53	2.94	14.91	1.36
All	735	100.00	79.40	0.11	11.79	3.07	17.03	3.97	19.82	2.71

Note: The table above describes manufacturer, wholesale, and retail prices and margins for 735 of 1,502 products (used in our estimation procedure) by category and size. The number of products corresponds to brand-size combinations, such as Smirnoff Vodka-750mL or Tanqueray Gin-1L. All averages are weighted by total liters sold. *Share* describes the share of total liters sold. The average *Proof* and percentage *Flavored* is reported. The average prices and margins are reported on a *per liter* basis.
The *Manufacturer Margin* is the difference between the manufacturer price and the estimated manufacturer marginal cost from the demand and supply model (net of federal excise taxes). All other columns in this table are observed rather than estimated.
Retailer Margin is the difference between the retail price and the wholesale price.
Wholesaler Margin is the difference between the wholesale price and manufacturer price plus state excise tax.
Federal alcohol excise taxes of $2.85 per liter of 80-proof spirits are levied on manufacturers. Connecticut state alcohol taxes, which are remitted by wholesalers, were raised from $1.18 to $1.42 per liter regardless of proof in July 2011.
Source: Harmonized Price and Quantity Data (top 750 products, average price under $60 per liter).

Table 2: Manufacturer Summary

	# Obs	Share	750mL	1L	1.75L	Manufacturer Price	Manufacturer Lerner	Wholesaler Price	Wholesaler Lerner	Retailer Price	Retailer Lerner
Diageo	155	32.70	0.16	0.21	0.63	11.75	0.30	17.00	0.23	19.26	0.11
Bacardi	48	14.20	0.21	0.34	0.45	14.30	0.24	20.03	0.23	22.63	0.11
Pernod	68	14.20	0.20	0.33	0.47	15.03	0.25	20.74	0.21	23.96	0.13
Jim Beam	102	8.30	0.18	0.23	0.59	9.59	0.27	14.55	0.24	17.56	0.14
Brown Forman	32	5.20	0.23	0.30	0.47	14.83	0.28	22.49	0.28	26.01	0.13
Skyy	26	2.90	0.27	0.06	0.67	11.18	0.22	16.00	0.21	18.58	0.13
Constellation Brands	6	2.80	0.19	0.11	0.71	7.43	0.28	12.45	0.29	14.37	0.13
Constellation	24	2.10	0.05	0.12	0.83	4.91	0.28	8.09	0.22	9.72	0.14
Star Industries	16	2.10	0.13	0.29	0.58	4.67	0.28	7.88	0.24	9.53	0.17
Imperial	6	2.10	0.19	0.10	0.71	5.72	0.27	9.16	0.23	12.16	0.24
MHW	44	2.00	0.41	0.16	0.43	11.68	0.24	16.97	0.23	20.77	0.17
Black Prince	7	2.00	0.10	0.29	0.62	3.97	0.28	5.93	0.11	7.15	0.17
Heaven Hill	21	1.50	0.18	0.05	0.77	6.65	0.24	10.12	0.20	12.05	0.15
White Rock	8	1.30	0.24	0.00	0.76	7.04	0.24	10.53	0.21	13.48	0.21
William Grant	17	1.30	0.22	0.12	0.65	10.40	0.26	16.02	0.25	18.62	0.11
Other	36	1.00	0.42	0.16	0.42	9.57	0.24	13.86	0.21	18.34	0.23
Remy-Cointreau	16	1.00	0.35	0.13	0.52	18.09	0.22	24.74	0.20	28.94	0.15
US Distributors	6	0.80	0.23	0.00	0.77	7.02	0.22	9.47	0.11	14.52	0.33
Sazerac	20	0.70	0.34	0.24	0.42	9.92	0.25	14.52	0.20	18.69	0.22
Moet Hennessy	10	0.60	0.41	0.37	0.22	24.35	0.23	31.02	0.17	37.43	0.17
LuxCo	19	0.60	0.17	0.38	0.45	7.13	0.25	10.97	0.23	14.60	0.23
MS Walker	10	0.20	0.08	0.48	0.45	5.33	0.22	7.32	0.09	10.99	0.25
McCormick	7	0.20	0.07	0.56	0.37	5.09	0.27	7.59	0.17	11.96	0.23
Proximo	3	0.10	1.00	0.00	0.00	20.02	0.26	29.27	0.26	37.64	0.21
Duggans	2	0.10	0.00	0.26	0.74	8.00	0.24	12.93	0.28	15.30	0.15
Infinium	1	0.00	0.00	0.00	1.00	5.54	0.26	8.84	0.24	10.78	0.17
Castle Brands	1	0.00	1.00	0.00	0.00	11.86	0.23	16.79	0.21	22.03	0.23

Note: The table above reports product shares, average prices, and Lerner markups by manufacturer for 735 of 1,502 products (used in our estimation procedure). The number of products corresponds to brand-size combinations, such as Smirnoff Vodka-750mL or Tanqueray Gin-1L. Average prices and Lerner markups are reported on a *per liter* basis. All averages are weighted by total liters sold.
Share describes the share of total liters sold by each manufacturer.
Manufacturer Lerner is the difference between the manufacturer price and the estimated manufacturer marginal cost from the demand and supply model (net of federal excise taxes) scaled by the estimated manufacturer marginal cost. All other columns in this table are observed rather than estimated.
Retail Lerner is the difference between the retail price and the wholesale price scaled by the retail price.
Wholesale Lerner is the difference between the wholesale price and manufacturer price plus state excise tax scaled by the wholesale price.
Federal alcohol excise taxes of $2.85 per liter of 80-proof spirits are levied on manufacturers. Connecticut state alcohol taxes, which are remitted by wholesalers, were raised from $1.18 to $1.42 per liter regardless of proof in July 2011.
Source: Harmonized Price and Quantity Data (top 750 products, average under $60 per liter).

Table 3: Parameter Estimates: Full Model

Π	Const	Price	1750mL
Below $25k	2.433	-0.736	-0.442
	(0.287)	(0.056)	(0.083)
$25k-$45k	0.243	-0.720	-0.258
	(0.328)	(0.095)	(0.097)
$45k-$70k	0.000	-0.768	0.000
	(0.000)	(0.094)	(0.000)
$70k-$100k	-0.960	-1.032	-0.275
	(0.324)	(0.094)	(0.096)
Above $100k	-3.762	-2.291	-0.794
	(0.262)	(0.074)	(0.077)
Σ^2			
Const	3.868	1.271	
	(0.740)	(0.150)	
Price	1.271	0.418	
	(0.150)	(0.031)	
Nesting Parameter ρ		0.27	
		(0.021)	
Fixed Effects		Brand+Quarter	
Model Predictions	25%	50%	75%
Own Elasticity	-5.072	-4.772	-4.484
Aggregate Elasticity	-0.545	-0.530	-0.506
Own Pass-Through	1.293	1.329	1.368
Observed Wholesale Markup (PH)	0.188	0.233	0.276
Predicted Wholesale Markup (PH)	0.222	0.238	0.255

Note: The table above reports parameter estimates from our RCNL model. The price coefficient is log-normally distributed so that $\alpha_i = -e^{\pi_k^p + \Sigma \cdot \nu_i}$ is always negative and more negative for values of π_k^p closer to zero. High-income consumers $\pi^p = -2.291$ have smaller coefficients than low-income consumers -0.736 and are thus *less* price sensitive.
Own pass-through is the change in equilibrium prices for product j (under PH) in response to a $1.00 increase in the price of good j.
Aggregate elasticity is the change in total spirits volume in response to a 1% price increase for all products.
Source: Harmonized Price and Quantity Data (top 750 products, average wholesale price below $60 per liter), 24 quarterly periods. Authors' calculations.

Table 4: Best Substitutes: Diversion Ratios 2013 Q2

	Median Price	% Substitution		Median Price	% Substitution
Capt Morgan Spiced 1.75 L ($15.85)			Cuervo Gold 1.75 L ($18.33)		
Bacardi Superior Lt Dry Rum 1.75 L	12.52	7.59	Cuervo Gold 1.0 L	21.32	3.26
Bacardi Superior Lt Dry Rum 1.0 L	15.03	2.06	Sauza Giro Tequila Gold 1.0 L	8.83	2.15
Smirnoff 1.75 L	11.85	1.87	Don Julio Silver 1.75 L	22.81	2.12
Bacardi Dark Rum 1.75 L	12.52	1.57	Smirnoff 1.75 L	11.85	1.80
Lady Bligh Spiced V Island Rum 1.75 L	9.43	1.46	Cuervo Gold 0.75 L	23.44	1.44
Woodford 0.75 L ($34.55)			Beefeater Gin 1.75 L ($17.09)		
Jack Daniel Black Label 1.0 L	27.08	4.25	Tanqueray 1.75 L	17.09	7.11
Jack Daniel Black Label 1.75 L	21.85	4.19	Gordons 1.75 L	11.19	2.55
Jack Daniel Black Label 0.75 L	29.21	2.66	Seagrams Gin 1.75 L	10.23	1.84
Makers Mark 1.0 L	32.79	2.46	Smirnoff 1.75 L	11.85	1.82
Makers Mark 0.75 L	31.88	1.53	Gilbey Gin 1.75 L	9.30	1.56
Dubra Vdk Dom 80P 1.75 L ($5.88)			Belvedere Vodka 0.75 L ($30.55)		
Popov Vodka 1.75 L	7.66	3.88	Absolut Vodka 1.75 L	15.94	3.34
Smirnoff 1.75 L	11.85	2.79	Grey Goose 1.0 L	32.08	2.71
Sobieski Poland 1.75 L	9.09	1.93	Smirnoff 1.75 L	11.85	2.36
Grays Peak Vdk Dom 1.75 L	9.16	1.78	Ktl1 Vdk Im 1.75 L	20.71	1.49
Bellows Vodka 1.0 L	6.21	1.49	Absolut Vodka 1.0 L	24.91	1.47

Note: The table above reports diversion rates for five popular products. Per liter wholesale prices are reported for 2013Q2. We compute the diversion ratio for a small price change $D_{j\to k} = \frac{\partial q_k}{\partial q_j} / \left|\frac{\partial q_j}{\partial q_j}\right|$.
A plain logit would predict the best substitute as the product with the largest overall share: Smirnoff Vodka (80-Proof, 1.75L) **with** $s_{jt} = 1.2\%$ **or** 4.37% **of "inside" sales.**
Source: Authors' calculations

Table 5: Counterfactual Policies to Limit Ethanol Consumption

Policy	Product Prices
Volumetric Tax	$p_{jt} = mc_{jt} + \tau_v$
Ethanol Tax	$p_{jt} = mc_{jt} + \tau_e \cdot ABV_{jt}$
Sales Tax	$p_{jt} = mc_{jt} \cdot (1 + \tau_r)$
Minimum Unit Price	$p_{jt} = \max\{mc_{jt}, \tau_u \cdot ABV_{jt}\}$
Monopoly	$\mathbf{p} = \arg\max_{\mathbf{p}} (\mathbf{p} - \mathbf{mc}) \cdot \mathbf{q}(\mathbf{p})$
Ramsey (Revenue)	$\mathbf{p}(\overline{R}) = \arg\max_{\mathbf{p} \geq \mathbf{mc}} CS(\mathbf{p})$ s.t. $(\mathbf{p} - \mathbf{mc}) \cdot \mathbf{q}(\mathbf{p}) > \overline{R}$
Ramsey (Ethanol)	$\mathbf{p}(\overline{E}) = \arg\max_{\mathbf{p} \geq \mathbf{mc}} CS(\mathbf{p})$ s.t. $\sum_j e_j\, q_j \leq \overline{E}$

Note: We examine seven policy alternatives to PH. In all counterfactuals PH pricing is replaced with taxes levied on a competitive wholesale market. *Sales* levies a single-rate sales tax (τ_r) on all spirits products to achieve the desired aggregate ethanol consumption level. Similarly, *Volume* and *Ethanol* model the impact of volumetric (τ_v) and ethanol-based (τ_e) taxes set to limit ethanol consumption. A *Minimum Price* enforces a floor based on ethanol content ($\tau_u \cdot ABV_{jt}\}$) but otherwise prices products competitively.
Finally, we examine the impacts of Ramsey prices where individual product prices are set to maximize consumer surplus while meeting different constraints. The first set of Ramsey prices are set to generate a required revenue (regardless of ethanol consumption). The second set of Ramsey prices is set to cap aggregate ethanol consumption (regardless of revenue generated).

Table 6: Distributional Impacts of Counterfactual Policies

		% Change in CS					
No Change in Ethanol	% Total Revenue	% Overall	Below $25k	$25k-$45k	$45k-$70k	$70k-$100k	Above $100k
Ramsey (Ethanol)	41.5	29.9	6.2	5.6	0.8	17.1	43.4
Minimum Price	52.9	29.8	5.9	6.4	3.1	17.9	42.9
Ethanol	280.4	11.2	1.2	0.9	0.4	5.4	16.7
Volume	283.8	10.1	-0.7	-2.0	-2.0	2.9	16.3
Sales	336.2	-16.1	-2.6	-0.9	-3.6	-9.9	-23.4
Ramsey (Revenue)	340.7	-6.3	-1.1	0.1	-1.3	-4.7	-9.1
-10% Ethanol							
Ramsey (Ethanol)	66.1	19.4	-5.2	-11.5	-14.9	-0.1	35.0
Minimum Price	74.2	19.4	-5.3	-10.7	-12.9	0.7	34.6
Ethanol	290.7	2.5	-8.9	-14.4	-13.9	-8.6	10.2
Volume	293.9	1.4	-11.0	-17.2	-16.3	-11.1	9.7
Sales	333.5	-24.4	-11.6	-14.4	-16.1	-21.5	-30.3
Ramsey (Revenue)	345.0	-16.9	-12.3	-16.6	-16.8	-19.5	-18.0
+10% Ethanol							
Ramsey (Ethanol)	22.0	39.7	17.4	24.4	18.2	35.5	50.4
Minimum Price	27.2	39.7	17.1	25.2	20.7	36.4	50.0
Ethanol	266.9	19.5	11.0	16.9	15.1	19.7	22.7
Volume	270.5	18.5	9.1	14.0	12.8	17.3	22.3
Ramsey (Revenue)	332.0	1.9	7.6	14.2	11.6	7.6	-2.5
Sales	333.6	-7.7	6.2	13.5	9.5	2.4	-16.5

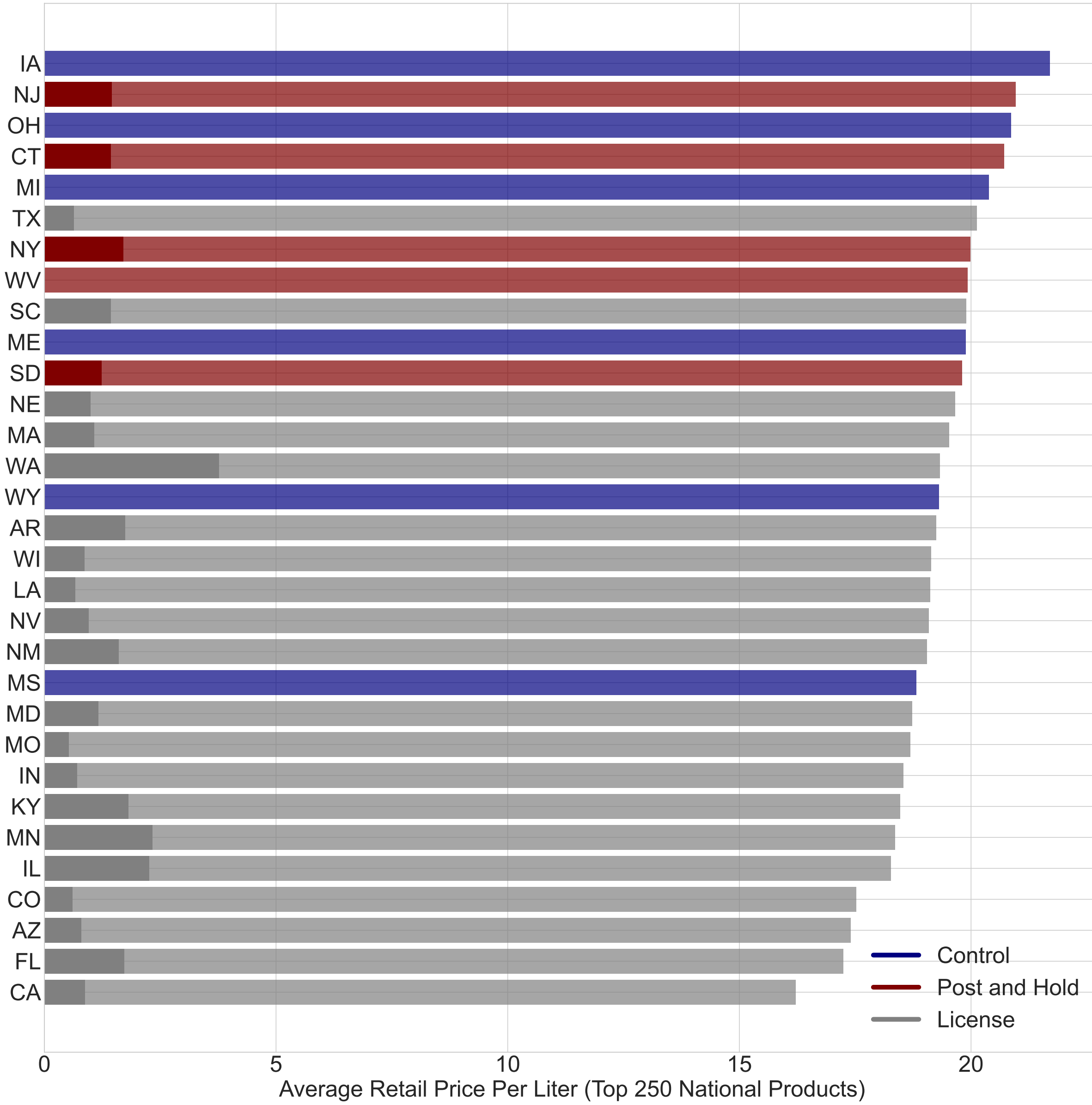
Note: The table above reports estimates of the impacts of the counterfactual policy alternatives described in Table 5 on tax revenue collected, overall consumer surplus and the distribution of consumer surplus across the five income bins. All effects are reported as percentage changes relative to the PH baseline. The top panel describes the impact of alternative policies that limit ethanol consumption to the same aggregate level as under PH while panels B and C report the effects of alternative policies that reduce and increase ethanol consumption by 10%, respectively. Revenue is calculated as the additional tax revenue raised by the state compared to the existing excise tax collections.
Source: Authors' calculations

Table 7: Reducing Overall Ethanol Consumption (Ethanol Taxes)

	No Change to Ethanol			No Change to Overall CS		
	Base	$wc = 1$	p^m	Base	$wc = 1$	p^m
% Δ Ethanol	0.00	-0.00	-0.00	-12.87	-12.62	-11.97
% Δ Tax Revenue	280.41	211.16	248.82	292.99	232.17	256.15
% Δ Manufacturer Profit	21.47	21.24	39.57	8.94	8.97	29.34
% Δ Total CS	11.18	10.94	10.09	-0.00	0.00	0.00
% Δ CS by Income						
Below $25k	1.23	0.79	1.31	-11.82	-12.00	-10.73
$25k-$45k	0.90	0.25	0.56	-18.57	-18.76	-17.44
$45k-$70k	0.36	-0.16	-0.64	-17.91	-18.02	-17.41
$70k-$100k	5.37	4.83	4.45	-12.59	-12.71	-11.97
Above $100k	16.73	16.64	15.21	8.25	8.34	7.72
Tax per Liter	5.48	4.48	5.02	6.50	5.47	5.83

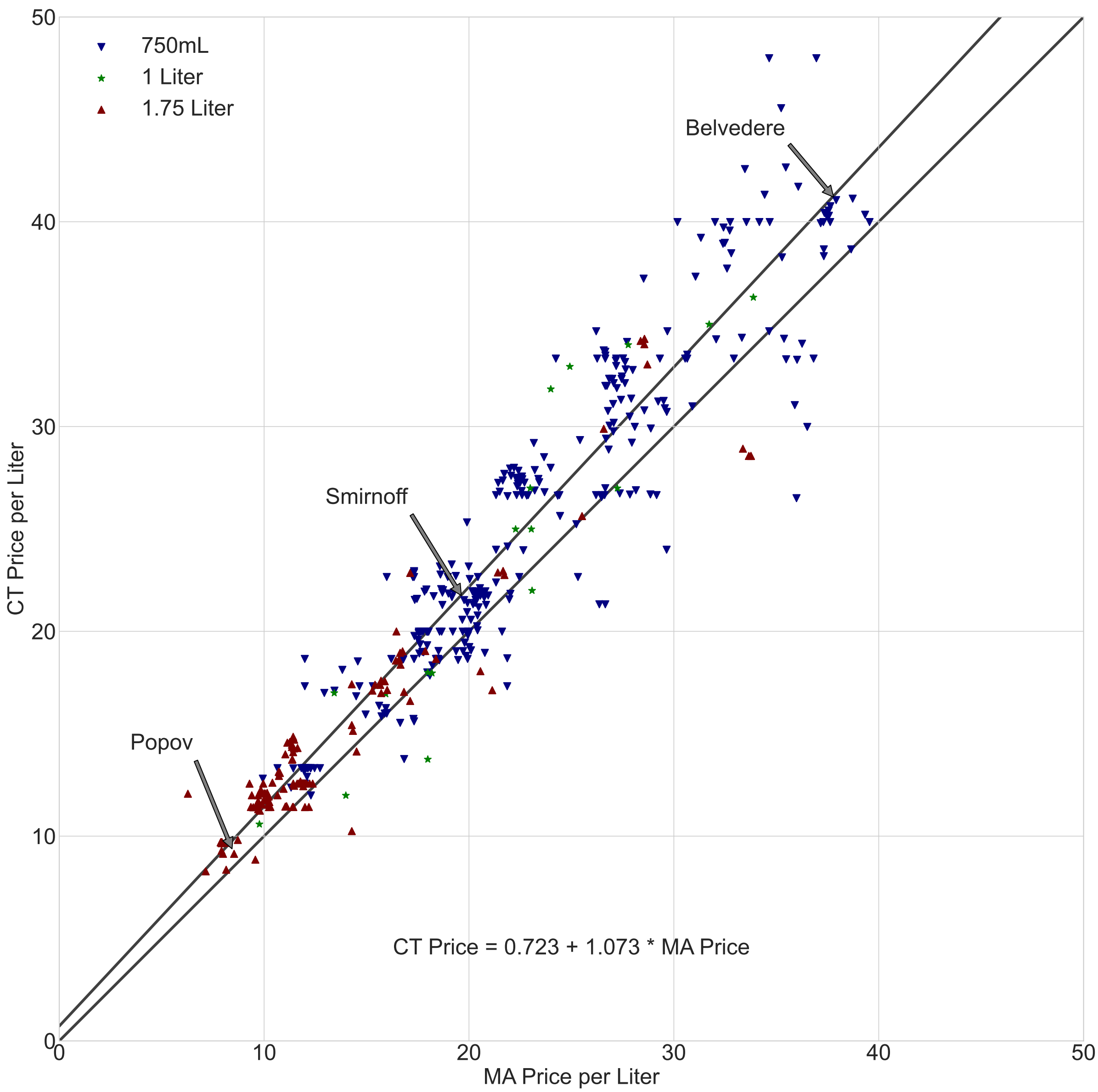
Note: The table above reports welfare estimates for the impacts of a counterfactual ethanol tax under two scenarios: (a) no change in overall ethanol consumption (b) minimizing ethanol consumption without reducing aggregate consumer surplus.
Under the Base scenario we set the wholesale price equal to the manufacturer price plus the taxes from Table 5. In the next columns, we allow for an additional $1 per liter wholesaling cost ($wc = 1$), or we allow manufacturers to endogenously set prices (p^m) in response to counterfactual taxes but with perfectly competitive wholesaling.
Manufacturer profits increase even when prices are held fixed because absent PH, consumers substitute to higher margin/quality products.
Tax Per Liter is reported as the tax on 1L of spirits at 80-Proof (40% Alcohol by Volume)
Source: Authors' calculations

Figure 1: Price Indices by State, National Consumption Bundle (2013)



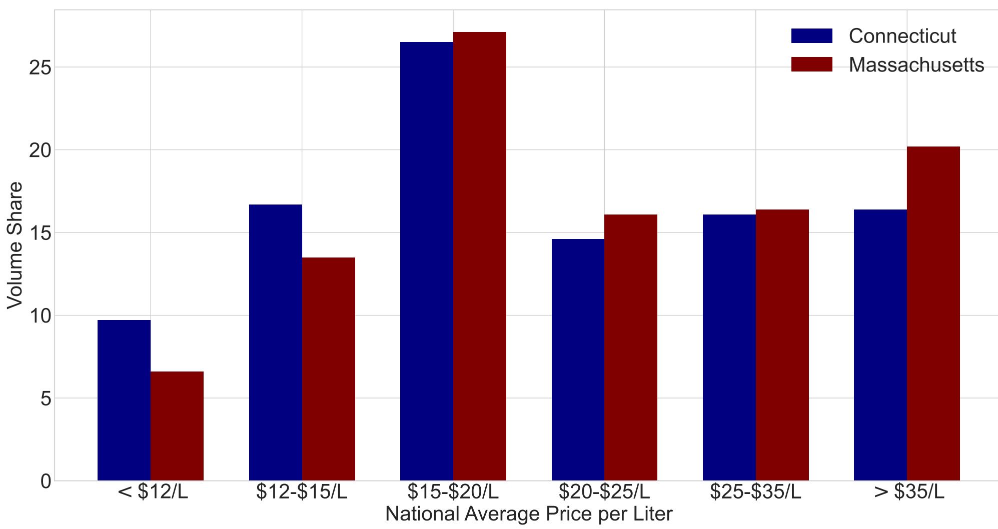
Note: The figure above plots the average retail price by state of the 250 best-selling products nation-wide. Retail prices in each state are weighted by the product's share within the top 250 national bundle by volume. As such, sales weights are constant across states so that the indices reflect only the differences in prices for the national bundle. License states such as Rhode Island and Delaware where we lack data describing sales of at least 1,000 products are excluded. Control states are shaded in blue, post-and-hold states in red and license states without post-and-hold regulations in grey. Darkly shaded bars on the left indicate state excise tax levied on the national bundle in license states (control states generally do not levy taxes on top of state markups).
Source: NielsenIQ Scanner Dataset.

Figure 2: Retail Prices for Vodka Products in Connecticut vs. Massachusetts (2013)

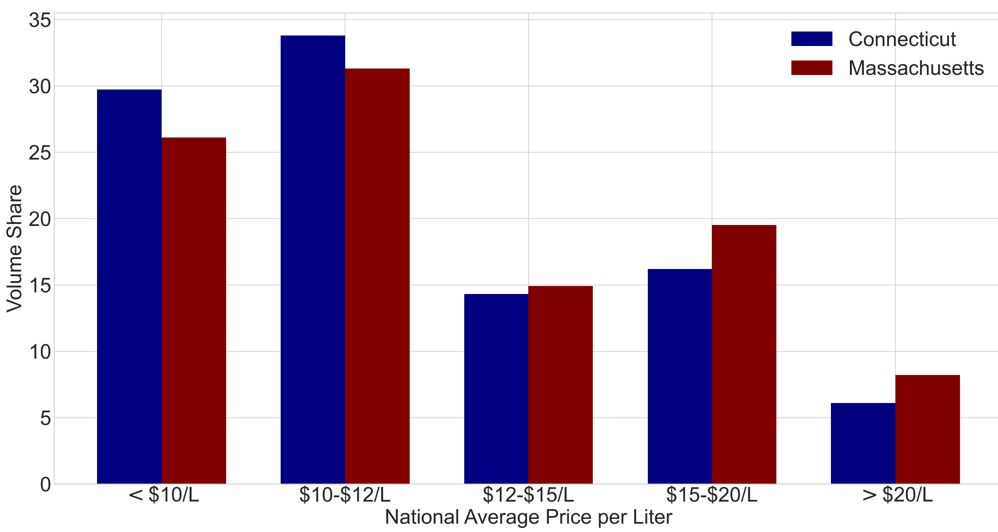


Note: The figure above compares the retail prices of individual products in Connecticut and the neighboring state of Massachusetts. Massachusetts prices are plotted on the x-axis and Connecticut prices are plotted on the y-axis with each dot representing brand-size combination, such as Smirnoff Vodka-750mL or Tanqueray Gin-1L. Prices are converted into dollars per liter and different colored markers denote 750mL (blue), 1000mL (green) and 1750mL (red) products. The dashed line plots the linear best fit and its coefficients are reported. The 45-degree line, corresponding to equal prices in Connecticut and Massachusetts, is shown as well.
Source: NielsenIQ Scanner Dataset.

Figure 3: Vodka Consumption in Connecticut and Massachusetts by National Price Per Liter (2013)



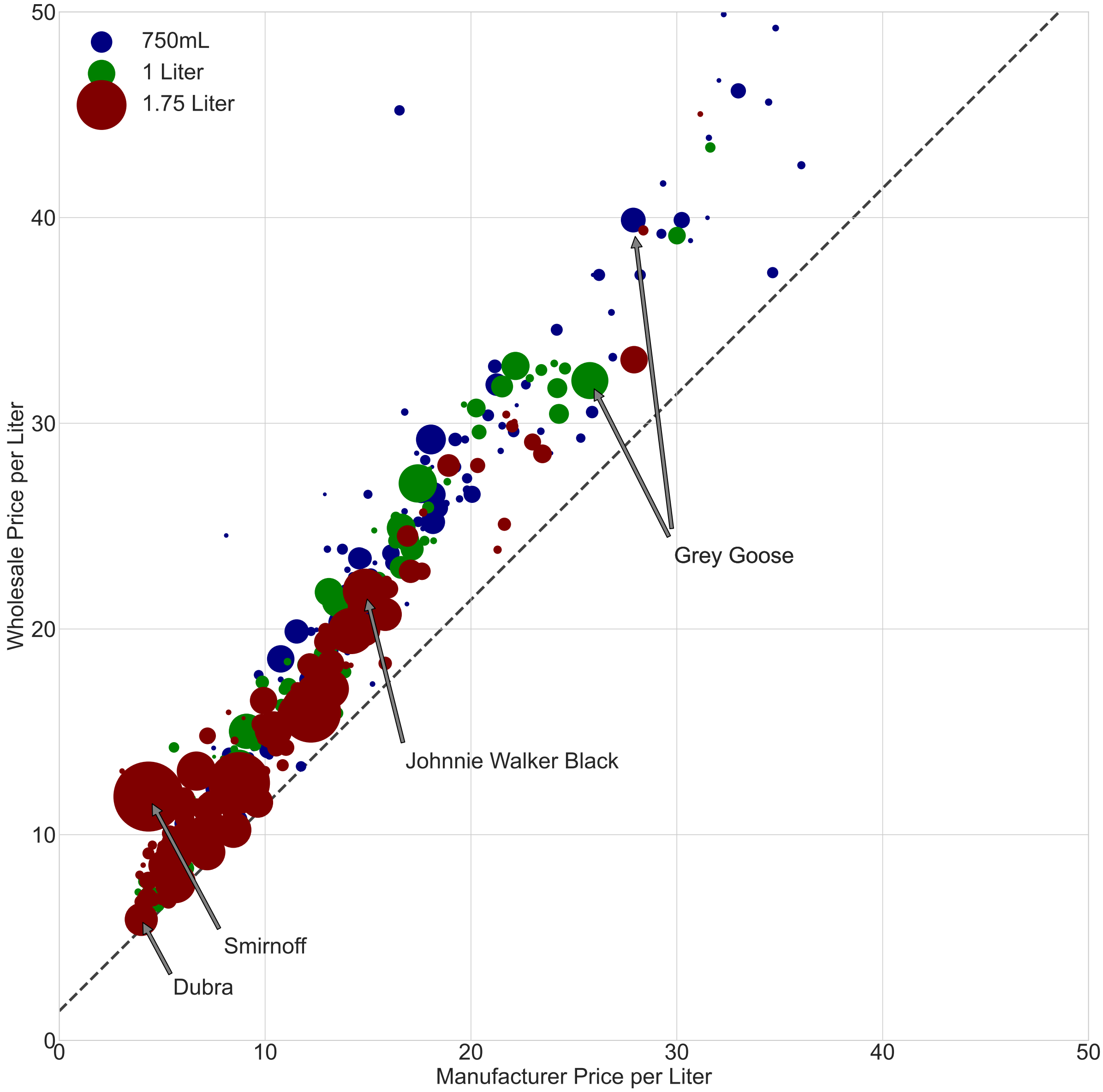
(a) 750mL Products



(b) 1.75L Products

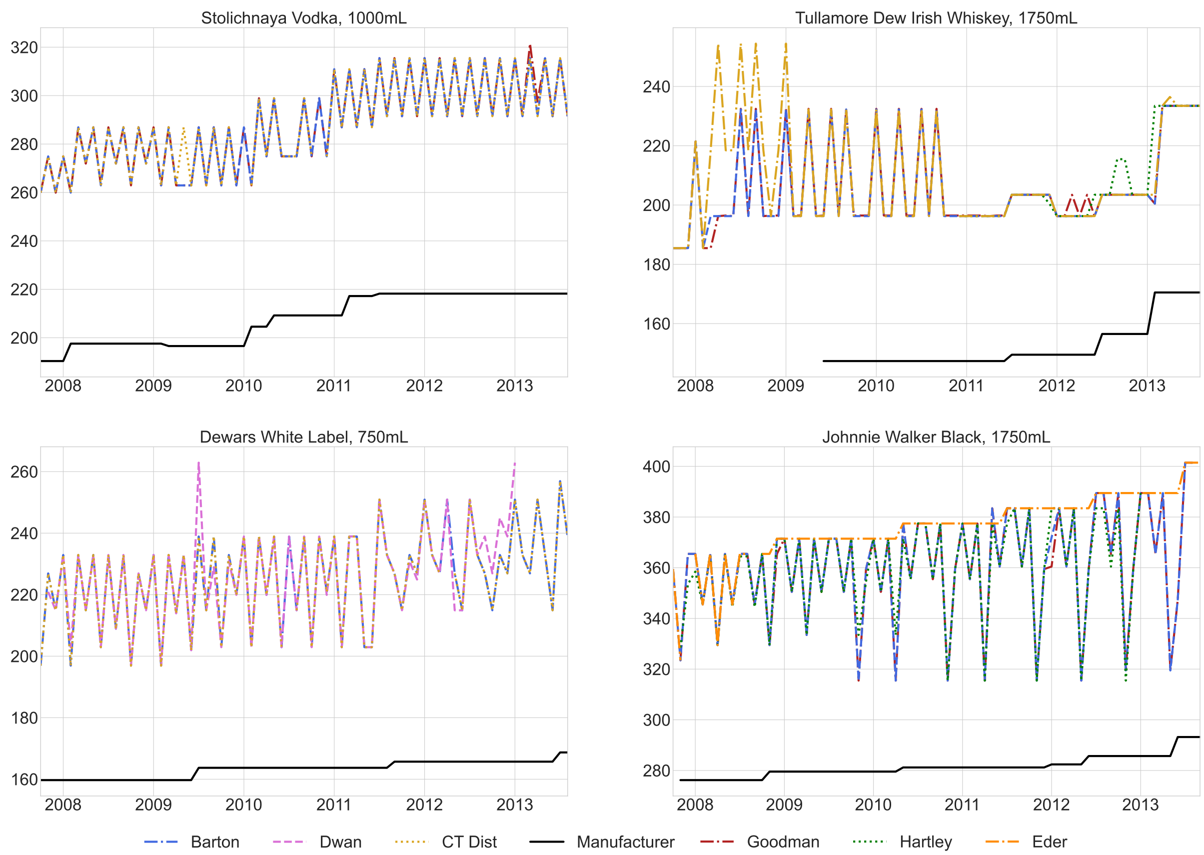
Note: The charts above show the share of vodka consumption by volume in Connecticut (blue) and Massachusetts (red) for 750mL and 1.75L products by national price per liter category. A product's national price category is determined using the average price per liter across all NielsenIQ markets outside of Connecticut designated market areas. For products only sold in Connecticut or Massachusetts the state price is used in place of the national price to calculate price per liter.
Source: NielsenIQ Scanner Data. All of 2013.

Figure 4: Manufacturer and Wholesale Prices Q2 2013



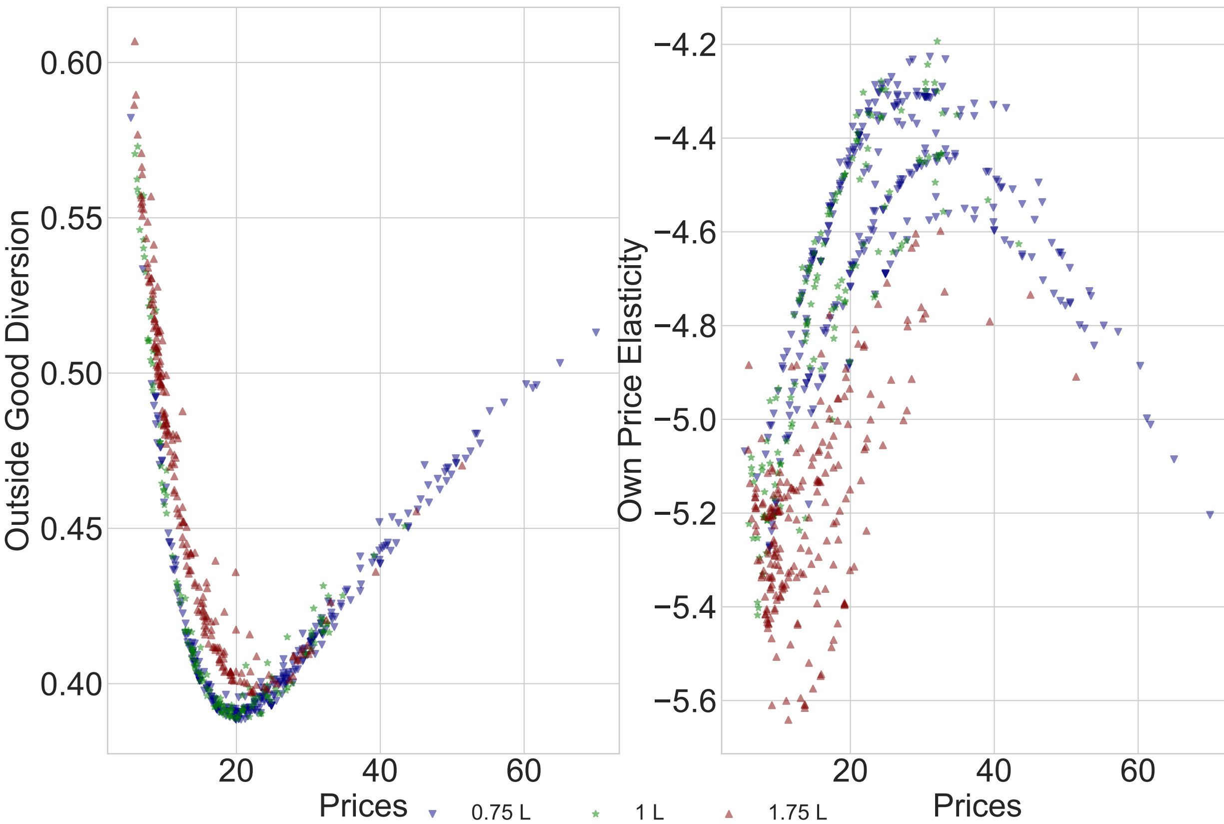
Note: The figure above plots the wholesale price against the manufacturer price, capturing how the ratio of wholesale to manufacturer price rises with manufacturer price. Prices are dollars per liter and different colored markers denote 750mL (blue), 1000mL (green) and 1750mL (red) products. Marker sizes are proportional to quarterly sales totals. The 45-degree line, corresponding to zero wholesale markup, is shown as well.
Source: Harmonized Price and Quantity Data. Period from 2013-04-01 to 2013-06-30.

Figure 5: Case Price by Wholesaler and Manufacturer Price, Four Top Selling Products



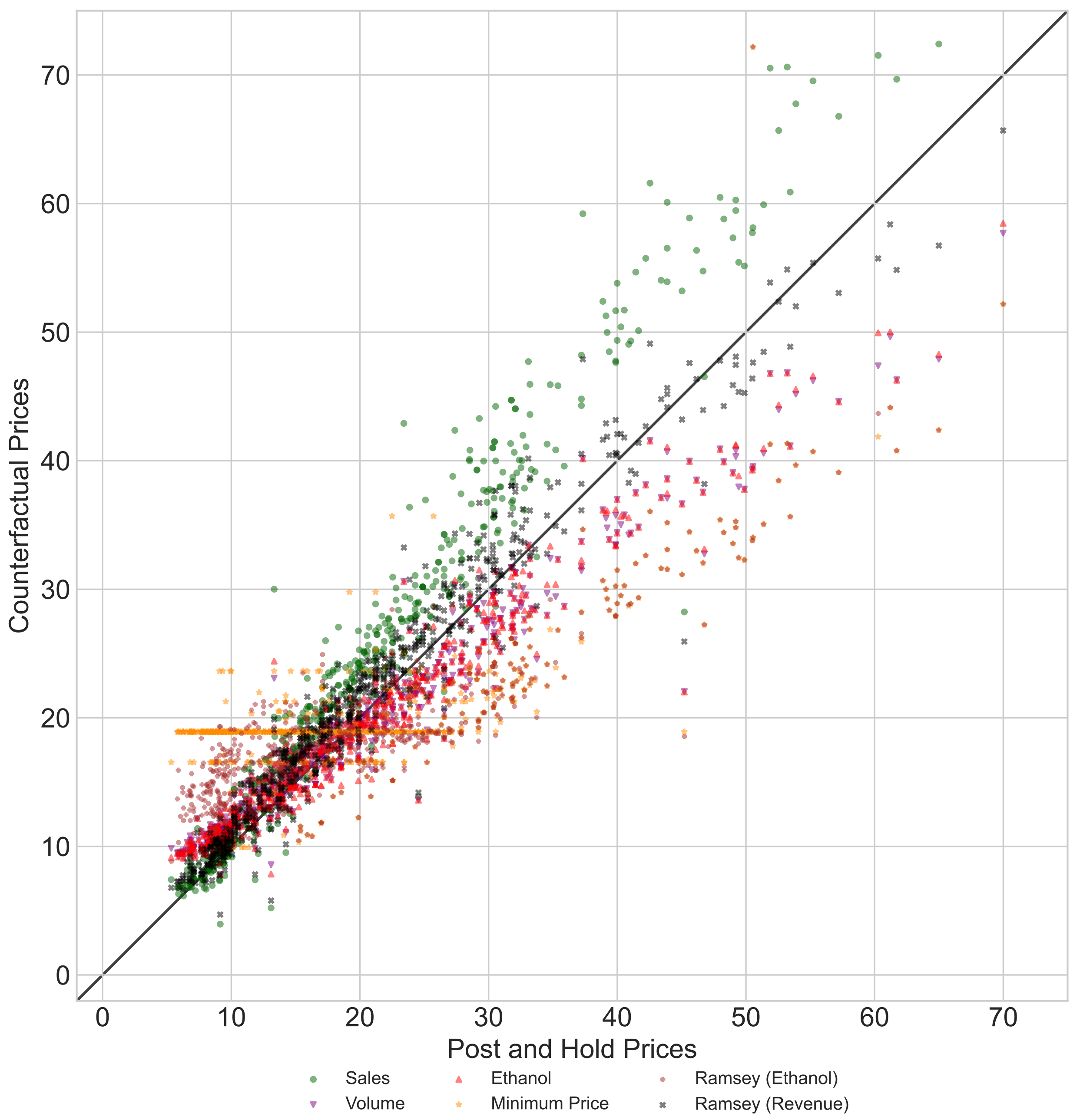
Note: The figure above plots monthly wholesale prices as well as the manufacturer price for four popular products between October 2007 and August 2013. Three wholesalers offer Stolichnaya Vodka, 1000mL (Goodman, Barton and CT Dist) and Dewars White Label, 750mL (Barton, CT Dist and Dwan), while four wholesalers sell Tullamore Dew, 1750mL (Barton, CT Dist, Goodman and Hartley) and Johnnie Walker Black, 1750mL (Barton, Eder, Goodman and Dwan) over the period. Prices offered by these distinct wholesalers overlap in the vast majority of months. While we might expect correlated wholesale price increases when manufacturer prices rise, which we observe, prices also exhibit considerable month-to-month changes between manufacturer price adjustments that happen in near lockstep across wholesalers.
Source: Harmonized Price and Quantity Data. Period from 2013-04-01 to 2013-06-30.

Figure 6: Estimated Own Elasticities and Diversion to the Outside Good



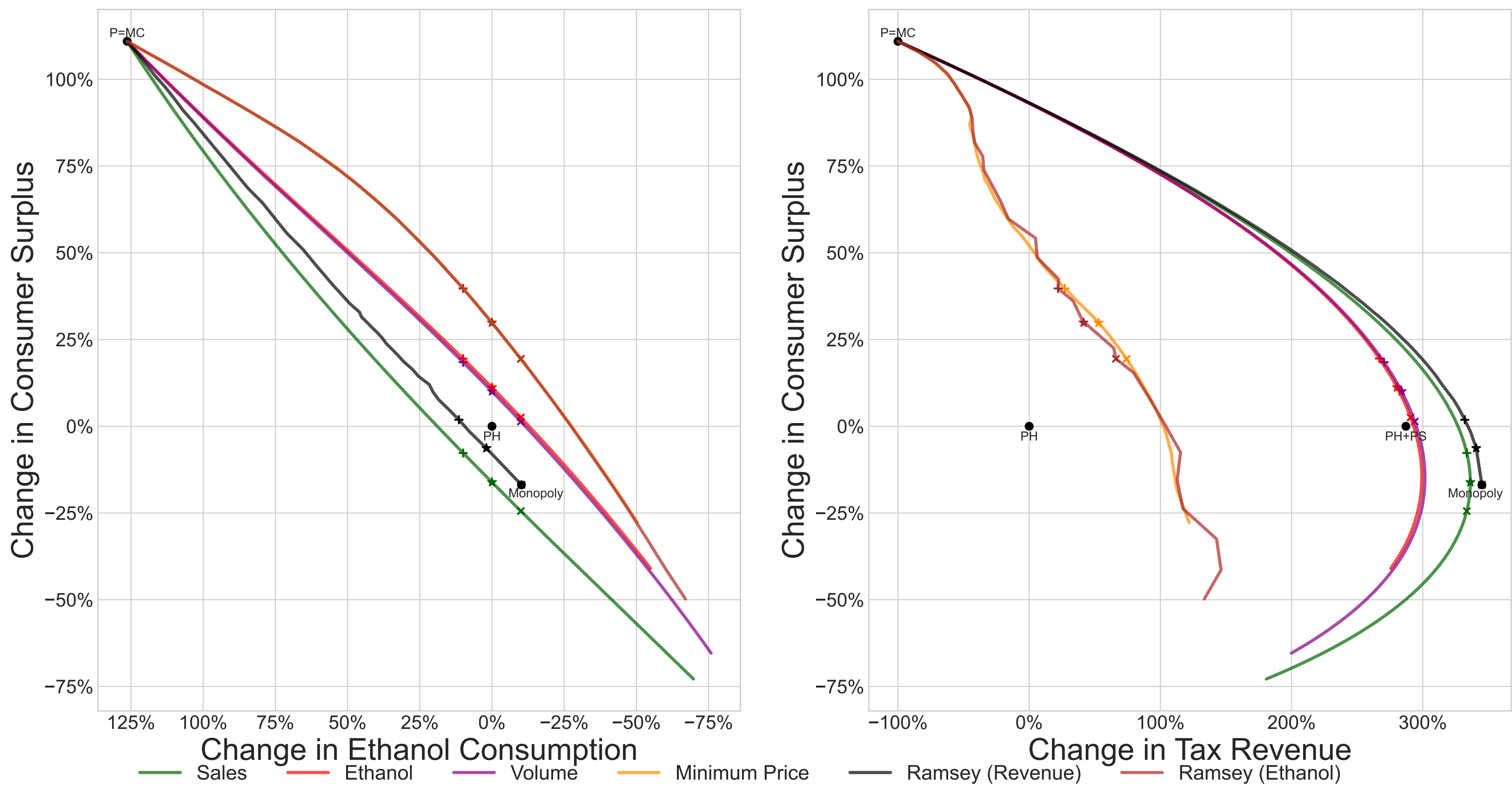
Note: The figure above plots estimated diversion ratios to the outside good (left panel) and own-price elasticities (right panel) against price where each observation is a product in 2013Q2. Diversion to the outside good is calculated as $D_{j\to 0} = \frac{\partial s_0}{\partial p_j} / \left|\frac{\partial s_j}{\partial p_j}\right|$ while own-price elasticities are given by: $e_{jj} = \frac{\partial s_j}{\partial p_j} \cdot \frac{p_j}{s_j}$. Low-price products have both higher diversion to the outside good and larger own-price elasticities, indicating that raising the prices of these products will most readily reduce aggregate ethanol consumption.

Figure 7: Prices Under PH vs. Other Policy Alternatives



Note: The figure above plots product prices under PH against prices under our counterfactual policy alternatives. In each of our counterfactual scenarios we consider a tax rate that would keep the overall level of ethanol fixed at the status quo. Our taxes follow the definitions in Table 5, and are levied on a competitive market where wholesale price equals manufacturer price. The solid black 45-degree line illustrates prices unchanged from PH.

Figure 8: Consumer Surplus vs. Tax Revenue and Ethanol Consumption Under Alternative Policies



Note: The figure above plots the change tax revenue (left panel) and ethanol consumption (right panel) against the change in consumer surplus for each of the policy alternatives to PH detailed in Table 5. The frontiers trace the trade-off between consumer surplus and tax revenue or ethanol consumption for each policy instrument. Stars indicate an aggregate ethanol consumption level equal to total ethanol under PH, while (×) denotes 10% less and (+) denotes 10% more ethanol consumption (in the left panel higher ethanol consumption corresponds to less tax revenue). We also mark competitive prices without taxes (denoted by P = MC), and PH pricing. In the left panel we indicate the revenue generate by existing excise taxes under PH pricing as well as the sum of tax revenue and wholesale profits generated by PH (denoted by PH+PS).

Appendices

A. Additional Theoretical Results

A.1. PH with a Single Product and Homogeneous Costs

We address this case in the main text and show that the first stage admits a dominant strategy of matching the lowest priced competitor so long as it is above your marginal cost.

Proof for Proposition 1

Consider a two-stage strategy of the form $\sigma_i(p_i^0, p_i^1)$. The second stage admits the unique dominant strategy where all players set $p_i^{1*} = \max\{c_i, \underline{p_i^0}\}$ where $\underline{p_i^0} = \min_i p_i^0$. For strategies of the form: $\sigma_i(p_i^0, \underline{p_i^0})$: $\sigma_i(p_i + \epsilon, \underline{p_i^0}) \geq \sigma_i(p_i, \underline{p_i^0})$ for $p_i \in [c_i, p_i^m)$. By induction the unique Nash Equilibrium to survive iterated weak dominance is $\sigma_i(p_i^m, \underline{p_i^0})$.

A.2. PH with a Single Product and Heterogeneous Costs

In the case of heterogeneous costs, the first stage becomes a bit more complicated. Begin by ordering the firms by marginal costs $c_1 \leq c_2 \cdots \leq c_N$. The market price $\hat{p}$ will be set by the lowest-cost firm (player 1). Other players play the iterated-weak-dominant-strategy $\sigma(p_i^0, p_i) = (p_i^m, \max\{\underline{p^0}, c_i\})$. Player 1 chooses p_i^0 to maximize the residual profit function:

$$\hat{p} = \underset{p_1^0 \in \{p_1^m, c_2, \ldots, c_n\}}{\arg\max} \pi_i(p_1^0) = \frac{(p_1^0 - c_1) \cdot Q(p_1^0)}{\sum_k I[c_k < p_1^0]}$$

Player 1 can choose either to play its monopoly price and split the market evenly with the number of firms for which $c_i \leq p_1^m$, or it can set a lower price to reduce the number of firms who split the market. When the cost advantage of player 1 is small, we expect to see outcomes similar to the monopoly price. As the cost advantage increases, it becomes more attractive for player 1 to engage in limit-pricing behavior. Because our wholesalers buy the same products from the upstream manufacturer/distillers in roughly similar quantities, we ignore the possibility of heterogeneous marginal costs in our empirical example. In practice, as long as the dispersion between heterogeneous costs is not too large, firms will not have an incentive to engage in limit-pricing.

A.2.1. PH with Heterogeneous Costs and Multiproduct Firms

We extend the single homogeneous good result to the case of heterogenous costs and multi-product firms, but continue to consider a single static Bertrand game. Now for each product j, the second stage admits the same form of a dominant strategy:

$$p_{ij}^* = \max\{c_{ij}, \underline{p_j^0}\} \quad \forall i, j$$

Firms now choose optimal strategies in first-stage prices, understanding what the outcome of the subgame will be, and facing both an *ad valorem* tax τ and a specific tax t:

$$\begin{aligned}
\pi_i &= \max_{p_{ij}:j\in J_i} \sum_{j\in J_i}(p_{ij}(1-\tau)-c_{ij}-t)\cdot q_{ij} \\
\frac{\partial \pi_i}{\partial p_k} &= q_{ik}(1-\tau)+\sum_{j\in J_i}(p_{ij}(1-\tau)-c_{ij}-t)\cdot\frac{\partial q_{ij}}{\partial p_k} \quad \forall i\in\mathcal{I}_k \qquad \text{(A.1)}
\end{aligned}$$

The insight from the homogenous goods case is that firms will not all operate by setting their FOC to zero. The idea is that firms act as a monopolist when decreasing prices, but act as price-takers when increasing prices. For each firm $i \in \mathcal{I}_k$ (where $\mathcal{I}_k$ denotes the set of firms selling product k), only the weaker condition $\frac{\partial \pi_i}{\partial p_k} \geq 0$ holds, and it is not necessarily true that $\frac{\partial \pi_i}{\partial p_k} \leq 0$ for all $i \in \mathcal{I}_k$.

If firms have sufficiently similar marginal costs,[81] no firm will engage in limit pricing and there will be a constant division of the market on a product by product basis (depending on how many firms sell each product). Let λ_{ik} be the share that i sells of product k. Under a constant division, $\lambda_{ik} \perp p_k$, we can write $q_{ik} = \lambda_{ik} Q_k$ where Q_k is the market quantity demanded of product k, so that $\forall i = 1, \ldots, N$:

$$Q_k\lambda_{ik}(1-\tau)+(p_k(1-\tau)-c_{ik}-t)\cdot\frac{\partial Q_k}{\partial p_k}\lambda_{ik}+\sum_{j\in J_i}(p_j(1-\tau)-c_{ij}-t)\cdot\frac{\partial Q_j}{\partial p_k}\lambda_{ij}\geq 0$$

$$\underbrace{Q_k(1-\tau)+(p_k(1-\tau)-c_{ik}-t)\cdot\frac{\partial Q_k}{\partial p_k}}_{\text{Single Product Monopolist}}+\underbrace{\sum_{j\in J_i}(p_j(1-\tau)-c_{ij}-t)\cdot\frac{\partial Q_j}{\partial p_k}\frac{\lambda_{ij}}{\lambda_{ik}}}_{\text{Cannibalization}}\geq 0$$

For each product k, except in the knife-edge case, the first-order condition holds with equality for exactly one firm i. This establishes a least upper bound:

$$\underbrace{Q_k(1-\tau)+(p_k(1-\tau)-t)\cdot\frac{\partial Q_k}{\partial p_k}}_{\text{Marginal Revenue}}+\min_{i:k\in J_i}\underbrace{\left[-c_{ik}\frac{\partial Q_k}{\partial p_k}+\sum_{j\in J_i}(p_j(1-\tau)-c_{ij}-t)\cdot\frac{\partial Q_j}{\partial p_k}\frac{\lambda_{ij}}{\lambda_{ik}}\right]}_{\text{Opportunity Cost of Selling}}=0 \qquad \text{(A.2)}$$

Intuitively, the firm that sets the price of good k under PH is the firm for which the opportunity cost of selling k is the smallest, either because of a marginal cost advantage, or because it doesn't sell close substitutes. Given the derivatives of the profit function, the other firms would prefer to set a higher price, the price they would charge if they were a monopolist selling good k. This arises because just as in the single good case, firms can unilaterally reduce the amount of surplus (by cutting their first-stage price), but no firm can affect the division of the surplus (since all price cuts are matched in the second stage).[82]

The competitive equilibrium under PH results in prices at least as high as the lowest-opportunity-cost single-product monopolist would have set, even though firms play a single period non-cooperative

[81]Formally we need that $c_{ik} \leq \underline{p}_k^0$ for all firms $i \in \mathcal{I}_k$

[82]Again this presumes that λ is fixed, and that firms do not engage in limit pricing for product k.

game, in which several firms distribute identical products. This also suggests a strategy we could observe in data. In the first stage, firms set their preferred "monopoly" price for each good, and in the second stage, firms update to match the lowest-opportunity-cost monopolist. In practice, we see very little updating in the second stage of the game, perhaps because the game is played month after month among the same players.

We can also do some simple comparative statics. Assume we increase the number of firms who sell product k. Normally this would lead to a decrease in price p_k. However, unless the entrant has a lower opportunity cost of selling than any firm in the existing market, prices would not decline, and we would expect the division of surplus λ_k to be reduced for the incumbents to accommodate the entrant. If this raises the opportunity cost of selling for the lowest-price firm, then more wholesale firms might counter-intuitively lead to higher prices.[83]

A.3. Comparing Markups Under PH and a Social Planner

In the main text we present the pricing rules of a PH wholesalers and a social planner maximizing social surplus while ensuring a minimum level of revenue and limiting external damage from the atmospheric externality of ethanol consumption. Below we derive the social planner's pricing rule (20) and compare markups set under PH to markups a social planner would set whether she is ignoring or addressing the ethanol externality.

A.3.1. Social Planner's Pricing Rule

We consider the problem of a social planner who faces demand $\mathbf{Q}(\mathbf{p})$, and sets the prices $p_j \in \mathbf{p}$ of all products to maximize total surplus subject to two additional constraints: a minimum level of revenue $\overline{R}$, and a maximum level of externalities arising from ethanol consumption $\overline{E}$.

$$\begin{aligned} \max_{\mathbf{p}} \quad & CS(\mathbf{Q}(\mathbf{p})) - C(\mathbf{Q}(\mathbf{p})) \\ \text{subject to} \quad & \mathbf{p} \cdot \mathbf{Q}(\mathbf{p}) - C(\mathbf{Q}(\mathbf{p})) \geq \overline{R} \\ \text{and} \quad & E(\mathbf{Q}(\mathbf{p})) \leq \overline{E}. \end{aligned} \tag{A.3}$$

where the social benefit of consumption is the same as the private benefit defined as the sum of the areas under the demand curves: $CS(\mathbf{Q}(\mathbf{p})) = \sum_{k \in \mathcal{J}} \int_0^{Q_k} p_k(Q1, Q_2, ..., Q_{k-1}, Z_k, Q_{k+1}, ..., Q_n) dZ_k$. The cost of producing alcoholic beverages is captured by $C(\mathbf{Q}(\mathbf{p}))$. We can write the social planner's Lagrangian:

$$\mathcal{L}(\mathbf{p}) = CS(\mathbf{Q}(\mathbf{p})) - C(\mathbf{Q}(\mathbf{p})) + \lambda_r(\mathbf{p} \cdot \mathbf{Q}(\mathbf{p}) - C(\mathbf{Q}(\mathbf{p})) - \overline{R}) - \lambda_e(E(\mathbf{Q}(\mathbf{p})) - \overline{E}). \tag{A.4}$$

The Lagrange multiplier λ_r measures the social value of an additional dollar of revenue, while λ_e measures the shadow cost of an extra unit of external damage caused by alcohol consumption. This nests the well-known *Ramsey problem.* A common (though by no means necessary) assumption is that the externality is *atmospheric*, or that it depends only on total ethanol consumption and not the source of the ethanol nor the identity of the consumer, such that $E(\mathbf{Q}(\mathbf{p})) = \sum_j e_j \cdot Q_j(\mathbf{p})$.[84]

[83] This is different from the mechanism in other work on price-increasing competition such as Chen and Riordan (2008).

[84] This assumption would be violated if for example, if tequila generates more externalities per unit of ethanol than vodka or if 1750mL bottles generate more externalities *per liter* than 750mL bottles. Recent work by Griffith et al.

The (interior solutions to the) first order conditions return the two constraints:

$$\frac{\partial \mathcal{L}}{\partial \lambda_r}: \quad \mathbf{p}\cdot\mathbf{Q}(\mathbf{p}) - C(\mathbf{Q}(\mathbf{p})) = \overline{R}$$
$$\frac{\partial \mathcal{L}}{\partial \lambda_e}: \quad E(\mathbf{Q}(\mathbf{p})) = \sum_{k\in\mathcal{J}} e_k \cdot Q_k(\mathbf{p}) = \overline{E}$$
$$\frac{\partial \mathcal{L}}{\partial p_j}: \quad \sum_{k\in\mathcal{J}} (p_k - mc_k)\frac{\partial Q_k}{\partial p_j} + \lambda_r \left(Q_j + \sum_{k\in\mathcal{J}} (p_k - mc_k)\frac{\partial Q_k}{\partial p_j}\right) - \lambda_e \sum_{k\in\mathcal{J}} e_k \frac{\partial Q_k}{\partial p_j} = 0.$$

Separating out product j, dividing through by $\frac{\partial Q_j}{\partial p_j}$ and re-writing the expression in terms of the diversion ratio, $D_{jk} = -\frac{\partial Q_k}{\partial p_j} / \frac{\partial Q_j}{\partial p_j}$[85] and own price elasticity $\epsilon_{jj} = \frac{\partial Q_j}{\partial p_j} \cdot \frac{p_j}{Q_j}$ gives:

$$(1+\lambda_r)(p_j - mc_j) - \lambda_r p_j \frac{1}{|\epsilon_{jj}|} - \lambda_e e_j - (1+\lambda_r)\sum_{k\neq j} D_{jk}(p_k - mc_k) + \lambda_e \sum_{k\neq j} D_{jk} e_k = 0.$$

which can be solved for p_j as the social planner's pricing rule:

$$p_j = \frac{|\epsilon_{jj}|}{|\epsilon_{jj}| - \frac{\lambda_r}{1+\lambda_r}} \left(mc_j + \frac{\lambda_e}{1+\lambda_r} e_j + \sum_{k\neq j} D_{jk}\left[p_k - mc_k - \frac{\lambda_e}{1+\lambda_r} e_k\right]\right)$$

or equation (20) in the main text.

The first term functions like the usual inverse elasticity rule Lerner markup with $\frac{\lambda_r}{1+\lambda_r} = \theta$ behaving like a conduct parameter where $\theta = 0$ corresponds to the perfectly competitive solution and $\theta = 1$ corresponds to the monopoly solution. The first two terms in parentheses, $mc_j + \frac{\lambda_e}{1+\lambda_r} e_j$, represent the effective marginal cost. When $\lambda_e > 0$, the marginal cost of production, mc_j, is augmented by the marginal external damage, e_j. The final term, $\sum_{k\neq j} D_{jk}\left[p_k - mc_k - \frac{\lambda_e}{1+\lambda_r} e_k\right]$, represents the *opportunity cost* of selling j, which is that fraction of consumers D_{jk} who switch to k as the price of j rises multiplied by the price less marginal cost (adjusted for the externality). Trading off these opportunity costs is a distinguishing feature of the multi-product Ramsey problem. Absent any revenue constraint, $\lambda_r = 0$, the first best solution to the planner's problem is to set prices at their Pigouvian rates $p_k = c_k + \lambda_e e_k$. More generally, for any revenue level and external damage (λ_r, λ_e) the Ramsey solution in (20) will maximize social surplus or minimize deadweight loss.

A.3.2. Comparing PH and the Planner's Pricing Rule Ignoring the Externality

As described in the main text, under PH the price for product j will be set by the wholesaler with the lowest opportunity cost of selling according to:

(2019) shows that if consumer preferences across beer, wine and spirits are correlated with their marginal externality of alcohol consumption, taxes that vary across categories will more effectively address the external damage of alcohol consumption.

[85] Antitrust practitioners will recognize D_{jk} as the diversion ratio from j to k given by $D_{jk} = \frac{\partial q_k}{\partial p_j} / \left|\frac{\partial q_j}{\partial p_j}\right|$.

$$p_j = \frac{|\epsilon_{jj}|}{|\epsilon_{jj}| - 1} \cdot \left[mc_j + \sum_{k \in \mathcal{J} \setminus j} \kappa_{jk} \cdot D_{jk} \cdot (p_k - mc_k) \right] \tag{A.5}$$

where κ_{jk} is the ratio of the pivotal (lowest opportunity cost) firm's market share of product k relative to product j, which may be zero for many products in the full set $\mathcal{J}$.

In contrast, a social planner facing a minimum revenue constraint, $\overline{R}$, but ignoring the externality would price product j according to the Ramsey rule:

$$p_j = \frac{|\epsilon_{jj}|}{|\epsilon_{jj}| - \frac{\lambda_r}{1+\lambda_r}} \left[mc_j + \sum_{k \in \mathcal{J} \setminus j} D_{jk} (p_k - mc_k) \right] \tag{A.6}$$

where λ_r is the shadow value of revenue.

For both PH wholesalers and the social planner, prices will be higher on products with less elastic demand and higher on products where consumers react to higher prices by switching to higher margin products (and not to the outside option).

But as the main text discusses, markups set by the social planner will differ from those set by wholesalers under PH in two key ways. First, the social planner's opportunity cost of selling any product will differ from the PH wholesaler. While the lowest opportunity cost wholesaler considers diversion to the other products it sells in accordance with $\kappa_{j,k}$, the social planner effectively sets $\kappa_{j,k} = 1$ for all substitutes. If a wholesaler controls a small share of the market for j and a large share for k it may be that $\kappa_{j,k} > 1$, though for many products we have $\kappa_{j,k} = 0$. Because she accounts for the broadest set of opportunity costs, the social planner will raise even the same amount of revenue as the PH wholesalers in aggregate with less deadweight loss than PH. Second, since $\frac{\lambda_r}{(\lambda_r+1)} < 1$, except in the limit where $\lambda_r \to \infty$, the term multiplying the opportunity cost will be smaller under the social planner than under PH wholesalers. This is because the profit maximizing firms don't place any weight on consumer surplus as the planner does.

A.3.3. Planner's Problem and Decentralized Solution with Externality

If the social planner aims to also also limit ethanol consumption while raising revenue $\overline{R}$, the pricing rule will also account for external damage[86]:

$$p_j = \frac{|\epsilon_{jj}|}{|\epsilon_{jj}| - \frac{\lambda_r}{1+\lambda_r}} \left[mc_j + \sum_{k \neq j} D_{jk} [p_k - mc_k] + \frac{\lambda_e}{1+\lambda_r} \left(e_j - \sum_{k \neq j} D_{jk} e_k \right) \right] \tag{A.7}$$

The first terms are as above with the addition of a term that relates prices and product-specific externalities. The price of product j rises with its marginal damage (e_j) but declines if consumers readily shift to high marginal damage products (e_k).

Another way to frame this problem is Dixit (1985)'s "principle of targeting", which is further detailed by Sandmo (1975) and Oum and Tretheway (1988), and shown to be reasonably general

[86]We assume the more interesting case where the revenue resulting from addressing the externality alone would not raise $\overline{R}$ and thus $\lambda_r > 0$.

by Kopczuk (2003). In this framework correcting the externality and hitting revenue target are independent problems. A fiscal authority seeking to raise revenue $\overline{R}$ would set the Pigouvian tax equal to marginal damage $\lambda_e e_j$, and then set the remaining markup on product j according to a Ramsey pricing rule with a revenue requirement of $\overline{R}' = \overline{R} - R^P$ where R^P is the total revenue raised from Pigouvian taxes.

This delineation of the problem highlights how addressing the externality flattens markups across the consumer's perceived "quality" gradient. Two products with the same proof will carry more similar markups under this pricing regime than one where $\overline{R}$ is solely raised by a pricing rule like equation A.5 where the externality is not addressed. Because the prices resulting from equation A.7 raise prices exactly on those products that most contribute to the public health externalities of spirits consumption, these prices will most efficiently raise $\overline{R}$. While our policy experiments deviate from this formulation as we seek to hold ethanol consumption under PH fixed rather than raising the same revenue as the wholesalers in aggregate, the intuition that the state sets lower markups than PH wholesalers on products favored by consumers for characteristics besides ethanol content will carryover to all of our policy experiments.

For any given product it is not clear whether price would be lower under a social planner of PH wholesaler. Low-quality but high ethanol products like Dubra vodka will see higher prices under the social planner as the price is raised to reflect its external damage relative to a PH price that reflected only its high own-price and cross-price elasticity. Low-proof products like Malibu rum, which is 21% ABV, on the other hand, may see price reductions as their external damage is relatively modest.

A.3.4. Counterfactual Analysis

Instead of setting prices to maximize social surplus subject to revenue and ethanol constraints, our counterfactual analysis sets product-specific ("Ramsey") prices that maximize consumer surplus subject to a revenue or ethanol constraint, as well as the constraint that no product is sold below marginal cost:

$$\begin{aligned} p^{\text{ramsey}}(\overline{E}, \overline{R}) &= \arg\max_{\mathbf{p} \geq \mathbf{mc}} CS(\mathbf{Q}(\mathbf{p})) \\ \mathbf{p} \cdot \mathbf{Q}(\mathbf{p}) - C(\mathbf{Q}(\mathbf{p})) &\geq \overline{R} \\ \text{and } E(\mathbf{Q}(\mathbf{p})) &\leq \overline{E}. \end{aligned}$$

This allows us to benchmark just how much better off the state could make consumers through alternative prices while raising a certain amount of revenue or achieving a specific aggregate ethanol reduction. Focusing on consumer welfare allows us to explicitly show these trade-offs. Because the state is setting product-specific taxes/prices on top of a competitive wholesale tier, the difference between price and cost summed across all products that is often considered producer surplus, is instead tax revenue in our counterfactuals. Figure 8 maps the trade-off between consumer surplus and tax revenue, including prices that maximize the combination of consumer surplus and tax revenue that comprises total surplus.

B. Empirical Implementation Details

B.1. Recovering Manufacturer Marginal Costs

In Table 7, we allow multi-product distillers/manufacturers (e.g. Bacardi, Diageo) to adjust their prices. We also report estimated manufacturer costs in Table 1. These require estimates not only of *manufacturer prices* and the manufacturer ownership matrix $\mathcal{H}_M$, which we observe, but also of *manufacturer marginal costs* which we do not.

This part builds on Jaffe and Weyl (2013) and Appendix E from Miller and Weinberg (2017) and almost exactly follows the implementation in Backus et al. (2021a); Conlon and Gortmaker (2020). The wrinkle here is that we observe the manufacturer prices $\mathbf{p^m}$ which simplify matters considerably, and we have the addition of the existing excise tax τ_0, which we show does not create any new issues.

We write the manufacturer's first order conditions as:[87]

$$\mathbf{p^m} = \mathbf{mc^m} + \left(\mathcal{H}_M \odot \left(\frac{\partial \mathbf{p^w}}{\partial \mathbf{p^m}} \cdot \Omega(\mathbf{p^w})\right)\right)^{-1} \mathbf{s}(\mathbf{p^w}) \tag{B.1}$$

This requires that we estimate the pass-through matrix $\frac{\partial \mathbf{p^w}}{\partial \mathbf{p^m}}$.

In order to do so, we re-examine the wholealers' problem: a system of J first order conditions and J prices $\mathbf{p^w}$, with manufacturer prices $\mathbf{p^m}$ and wholesaling costs (including taxes) τ_0 serving as parameters:[88]

$$f(\mathbf{p^w}, \mathbf{p^m}, \tau_0) \equiv \mathbf{p^w} - \underbrace{(\mathbf{p^m} + \tau_0)}_{=\mathbf{mc^w}} - \underbrace{(\mathcal{H}_{PH}(\kappa) \odot \Omega(\mathbf{p^w}))}_{\equiv \Delta(\mathbf{p^w})}{}^{-1} \mathbf{s}(\mathbf{p^w}) = 0 \tag{B.2}$$

Where $\Delta(\mathbf{p^w}) \equiv \mathcal{H}_{PH} \odot \Omega(\mathbf{p^w})$ is the PH augmented matrix of demand derivatives.

We differentiate the wholesalers' system of FOC's with respect to p_l, to get the $J \times J$ matrix with columns l given by:

$$\frac{\partial f(\mathbf{p^w}, \mathbf{p^m}, \tau_0)}{\partial p^w_\ell} \equiv e_\ell - \Delta^{-1}(\mathbf{p^w}) \left[\mathcal{H}_{PH} \odot \frac{\partial\, \Omega(\mathbf{p^w})}{\partial\, p^w_\ell}\right] \Delta^{-1}(\mathbf{p^w})\, \mathbf{s}(\mathbf{p^w}) - \Delta^{-1}(\mathbf{p^w}) \frac{\partial \mathbf{s}(\mathbf{p^w})}{\partial p^w_\ell}. \tag{B.3}$$

The complicated piece is the demand Hessian: a $J \times J \times J$ tensor with elements (j, k, ℓ), $\frac{\partial^2 s_j}{\partial p^w_k \partial p^w_\ell} = \frac{\partial^2 \mathbf{s}}{\partial \mathbf{p^w} \partial p^w_\ell} = \frac{\partial\, \Omega(\mathbf{p^w})}{\partial\, p^w_\ell}$.

We can follow Jaffe and Weyl (2013) and apply the multivariate IFT. The multivariate IFT says that for some system of J nonlinear equations $f(\mathbf{p^w}, \mathbf{p^m}, \tau_0) = [F_1(\mathbf{p^w}, \mathbf{p^m}, \tau_0), \ldots, F_J(\mathbf{p^w}, \mathbf{p^m}, \tau_0)] =$

[87] With some additional modifications, we could follow Miller and Weinberg (2017) and interpolate between no manufacturer response and the fully flexible manufacturer response. We find that the two outcomes are not far enough apart for this to matter.

[88] Because the marginal costs are additively separable we can also define the system as $f(\mathbf{p}, 0, 0) + \mathbf{c} + \tau_0 = 0$.

$[0, \ldots, 0]$ with J endogenous variables $\mathbf{p^w}$ and J exogenous parameters $\mathbf{p^m}$.

$$\frac{\partial \mathbf{p^w}}{\partial \mathbf{p^m}} = -\begin{pmatrix} \frac{\partial F_1}{\partial p^w_1} & \cdots & \frac{\partial F_1}{\partial p^w_J} \\ \cdots & \cdots & \cdots \\ \frac{\partial F_J}{\partial p^w_1} & \cdots & \frac{\partial F_J}{\partial p^w_J} \end{pmatrix}^{-1} \cdot \underbrace{\begin{pmatrix} \frac{\partial F_1}{\partial p^m_k} \\ \cdots \\ \frac{\partial F_J}{\partial p^m_k} \end{pmatrix}}_{=-\mathbb{I}_J} \tag{PTR}$$

Because the system of equations is additive in $\mathbf{p^m}$ and τ_0 this simplifies dramatically $\frac{\partial f(\mathbf{p^w},\mathbf{p^m},\tau_0)}{\partial \mathbf{p^m}} = -\mathbb{I}_J$. The pass-through matrix (PTR) is merely the inverse of the matrix whose columns are defined in (B.3).[89]

In the counterfactual world, with competitive wholesaling, the pass-through matrix reduces to the identity matrix plus any ad valorem taxes $\frac{\partial \mathbf{p}}{\partial \mathbf{m}} = I_J \cdot (1 + \tau_r)$, while the effective marginal cost becomes the production cost $\mathbf{c_m} + \tau$, where τ are any per-unit taxes.

Implmentation Notes:

1. PyBLP method `compute_passthrough()` will deliver (PTR) (this is very time consuming).
2. PyBLP method `compute_demand_jacobians()` will deliver $\Omega(\mathbf{p^w})$.
3. $\mathcal{H}_m$ is the ownership matrix at the manufacturer level (ie: 1's if both products are owned by Diageo, Bacardi, etc.).
4. $\mathbf{s_t}$ are observed shares and we can plug into (B.1) to get $\mathbf{mc^m}$.
5. Because $\mathbf{mc^m}$ is backed out of (B.1) it is the combination of production costs and federal excise taxes. We never need to separate the two for any counterfactuals.
6. Once we recover $\mathbf{c_m}$, we can re-solve (B.1) for the optimal manufacturer prices $\mathbf{p^m}(\mathbf{mc^m} + \tau)$ at each proposed level of taxes. PyBLP method `compute_prices()` will work fine using $\mathcal{H}_m$ and the tax-augmented marginal cost.[90]

B.2. Micro Moments

B.2.1. Demographic Interactions

In `PyBLP` Conlon and Gortmaker (2023), all micro moments take the following form, where we match $\overline{v}_m$ with the model simulated analogue. We use the same number of Monte Carlo draws in each market t so that $w_{it} = \frac{1}{I}$ and the general formula simplifies:

$$v_{mt}(\theta_2) = \frac{\sum_{i \in I_t} \sum_{j \in J_t \cup \{0\}} s_{ijt}(\theta_2) \cdot w_{d_m ijt} \cdot v_{mijt}}{\sum_{i \in I_t} \sum_{j \in J_t \cup \{0\}} s_{ijt}(\theta_2) \cdot w_{d_m ijt}} \tag{B.4}$$

Where $w_{d_m ijt}$ are the survey weights and v_{mijt} is the value. We match the following moments:

[89] Our average product-level own pass-through rate is 1.3 which is *overshifted*, but consistent with reduced form estimates in our prior work Conlon and Rao (2020).

[90] This works because excise and volumetric taxes are independent of prices and the fact that statutory incidence is downstream of manufacturers is irrelevant.

1. $w_{dijt} = 1\{j \neq 0\}$ and $v_{mijt} = 1\{\text{Income}_i \in \text{bin}_k\}$ for each market $t \in T$ and "inside" goods only. This allows us to match:

$$\mathbb{P}\left[\text{Income}_i \in \text{bin}_k \mid Purchase\right]$$

2. $w_{dijt} = 1\left\{j \neq 0, x_j = 750mL\right\}$ and $v_{mijt} = 1\{\text{Income}_i \in \text{bin}_k\}$ for each market $t \in T$ and "inside" goods only. This allows us to match:

$$\mathbb{P}\left[\text{Income}_i \in \text{bin}_k \mid 750mL\right]$$

3. $w_{dijt} = 1\left\{j \neq 0, x_j = 1750mL\right\}$ and $v_{mijt} = 1\{\text{Income}_i \in \text{bin}_k\}$ for each market $t \in T$ and "inside" goods only. This allows us to match:

$$\mathbb{P}\left[\text{Income}_i \in \text{bin}_k \mid 1750mL\right]$$

4. $w_{dijt} = 1\{j \neq 0, \text{Income}_i \in \text{bin}_k\}$ and $v_{mijt} = p^w_{jt}$ for each market $t \in T$ and "inside" goods only. This allows us to match:

$$\mathbb{E}\left[p^w_{jt} \mid \text{Income}_i \in \text{bin}_k \text{ and } Purchase\right]$$

We match a different set of values for each income bin. To avoid colinearity (probabilities sum to one) we exclude the middle income bin for the first three sets of moments. We match a different set of moments for each *year* from 2007-2013, rather than each *market* (a quarter). This is because the NielsenIQ Household Panelist data samples different households each year.

These moments are straightforward to calculate from the NielsenIQ Household Panelist data, and don't require any other data sources beyond the NielsenIQ data. The exception is that for each product, NielsenIQ reports the *retail price* and we must find the corresponding *wholesale price* because the model is defined in terms of *Wholesale Demand*.

We report an aggregated version of our demographic moments in Table B.1. In practice estimate separate micro moments for each year, but here we report the simple average value across all years (which does not account for different variance across years). This is meant to highlight the patterns in the data that discipline the parameters, and approximate the goodness of fit. As an example, we do a good job matching the distribution of income conditional on purchase, and conditional on purchasing a larger product, though we struggle a bit to capture the demand from the lowest income group. Because this group is so small, the GMM weighting matrix ends up placing a very small weight on matching the behavior of the lowest income group.

We tend to consistently over-estimate the average price paid by each income group because the distribution of prices (even conditional on income) of purchases by NielsenIQ panelists is significantly lower than the overall distribution of prices in the shipment data. In part, they tend to buy inexpensive products at the large discount chain in the NielsenIQ data. In general, we get the correlation between income and price paid correct even though the levels in the NielsenIQ data would be impossible to match given the overall market shares observed in our data. This is less of a problem because we rely on matching the average markup from the supply moments to get the price sensitivity correct.

Income	$\mathbb{P}$(Income|Purchase)	Estimated	$\mathbb{P}$(Income|1750)	Estimated	$\mathbb{E}[P\|\text{Income}]$	Estimated
Below $25k	0.22	0.17	0.20	0.21	9.97	12.56
$25k-$45k	0.14	0.12	0.13	0.16	11.91	13.42
$45k-$70k	0.17	0.17	0.18	0.23	12.39	13.35
$70k-$100k	0.12	0.13	0.12	0.15	13.66	14.70
Above $100k	0.35	0.41	0.36	0.25	17.98	22.17

Table B.1: Micro Moment Fit

B.2.2. Second-Choice Moments

These moments are relatively straightforward to define in `PyBLP`, and the construction of the moments from the NielsenIQ dataset is described in detail in the text of the paper. We provide the implementation details below which closely follow (Conlon and Gortmaker, 2023).

We define $w_{dijkt} \propto \mathcal{M}_t \cdot 1\{j,k \neq 0\}$ which corresponds to a random sample of consumers whose first and second choices were both inside alternatives. We then define two parts a $v_{ijkt}^{top}(\theta) = 1\{j \in \mathcal{J}_g \text{ and } k \in \mathcal{J}_g\}$ and $v_{ijkt}^{bottom}(\theta) = 1\{k \in \mathcal{J}_g\}$ and define the moment as the ratio of the two micro-moment parts: $f(\theta_2) = v^{top}(\theta_2)/v^{bottom}(\theta_2)$.

We use (Eq 21) from Conlon and Gortmaker (2023) in place of (B.4):

$$v_p(\theta_2) = \frac{\sum_{t\in\mathcal{T}}\sum_{i\in\mathcal{I}_t}\sum_{j\in\mathcal{J}_t\cup\{0\}}\sum_{k\in\mathcal{J}_t\cup\{0\}\setminus\{j\}} w_{it}\cdot s_{ijkt}(\theta_2)\cdot w_{d_pijkt}\cdot v_{pijkt}}{\sum_{t\in\mathcal{T}}\sum_{i\in\mathcal{I}_t}\sum_{j\in\mathcal{J}_t\cup\{0\}}\sum_{k\in\mathcal{J}_t\cup\{0\}\setminus\{j\}} w_{it}\cdot s_{ijkt}(\theta_2)\cdot w_{d_pijkt}}. \tag{B.5}$$

All that remains is to define $s_{ijkt}(\theta_2)$ (the probability that an individual will have first-choice product and j will have second choice product k). This is easy to compute within the model.

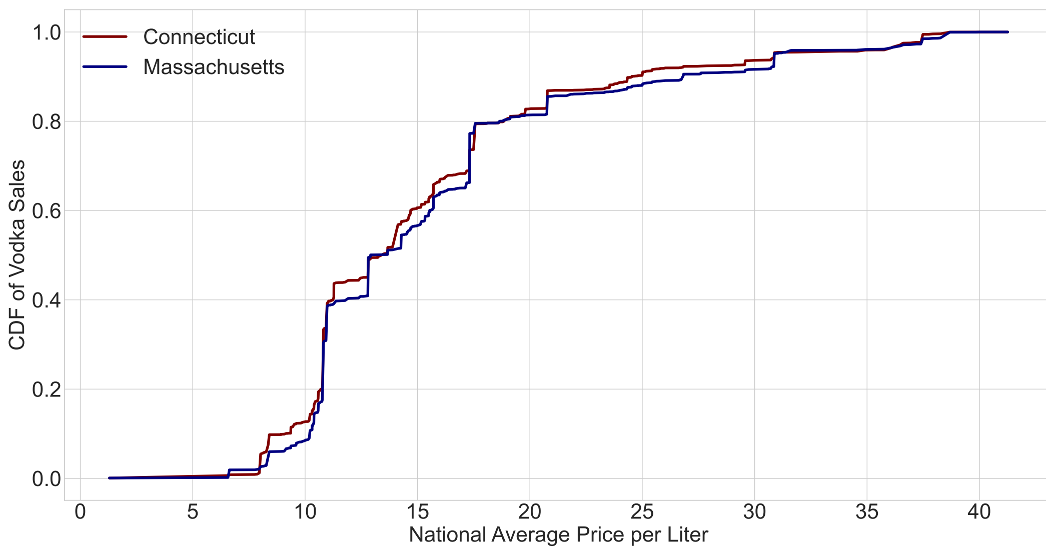
The idea is that for every pair of products (j,k) we compute the joint probability that j is first-choice and k is the second $s_{ijkt}(\theta_2)$ given the parameters and then the v_{pijkt} are simply indicator functions for whether both products are Vodkas (top) or the first-choice product is Vodka (bottom). We can repeat this for each of the product categories. We illustrate how these moments are used to estimate ρ in Appendix C.2.

C. Robustness Tests

C.1. Alternative to Figure 3

One concern about Figure 3 is that our choice of price bins may seem arbitrary. A better but more complicated way to address this concern is to rank all vodka products by their national price per liter and compare the CDF of purchases for Connecticut and Massachusetts. If cumulative sales are larger at each national price, then we can say that Connecticut consumes an inferior bundle of vodkas. (We could repeat the exercise for all products, but that might conflate preferences for different categories: Vodka vs. Tequila or Scotch Whisky for "quality"). We plot this in Figure C.1 and show that the bundle in CT nearly FOSD the bundle in MA (except for a few ties).

Figure C.1: CDF of Vodka Consumption by National Average Price Per Liter



Note: The chart above shows the share of vodka consumption by national price per liter category. A product's national price category is determined using the average price per liter across all NielsenIQ markets outside of Connecticut-designated market areas. For products only sold in Connecticut or Massachusetts, the state price is used in place of the national price to calculate the price per liter.

C.2. Sensitivity of Demand Estimates

C.2.1. Varying the ρ Parameter

We explore the sensitivity of our parameter estimates by fixing the nesting parameter ρ at different increments between $\rho = 0$ (plain logit) and $\rho = 1$ (all substitution within the nest) and re-estimating the remaining parameters of the model. We include the demand moments, the supply moments, the micro-moments, and the second-choice category moments.

We compute a one-step GMM estimator using the same instruments and the same (2SLS) weighting matrix for each value of ρ. As indicated in Table C.1, $\widehat{\rho} = 0.242$ minimizes the GMM objective in (18). We also report our second-stage GMM estimates (which use the approximation to the optimal instruments, and an updated weighting matrix $\widehat{W})(\widehat{\theta})$ which gives the $\widehat{\rho} = 0.269$ that we report in Table 3.

As we increase ρ in Table C.1 we see that more individuals stay within the same product category ($Vodka \rightarrow Vodka$) and fewer divert to the outside good. At our estimate $\widehat{\rho} = 0.269$ this corresponds to 46% of consumers switching to the outside good, and 69% of consumers switching from one Vodka to another if the first-choice product was unavailable (target 50.6%). For the other categories $\widehat{\rho} = 0.269$ tends to over-estimate the "same category" switching behavior (Rum 56.3% vs 20.2%, NA Whiskey 55.6% vs. 26.1%, UK Whiskey 52.5% vs. 33.2%). The exception is Gin for which the model predicts 50.0% while the target from the NielsenIQ panelist data is 60.4%. Absent these "second-choice moments" we would estimate a value of $\rho \in (0.45, 0.5)$ which would imply that 70% of consumers would substitute within the category, so that including these moments pushes us towards smaller values of ρ.

It is important to note that because we impose the supply moments, we are effectively constraining the markups to match (on average), so that each row in Table C.1 has a nearly identical average Lerner markup $(p^w_{jt} - p^m_{jt} - \tau_{jt})/p^w_{jt} = 0.238$. As we increase ρ (and fix the markup) the own- (and cross-) elasticities increase so that consumers become more elastic, but there is less substitution to the outside good, more to other products in the same category, and the overall elasticity of alcohol with respect to a 1% tax declines. This aggregate elasticity captures how quickly consumers substitute away from spirits as we raise the price, and ends up being a good barometer of the welfare impacts of the tax alternatives. It is important to note that as we adjust ρ, other parameters (particularly σ_0 and π_0, which govern overall taste for spirits) also adjust so that ρ is not the only parameter that determines the own- and cross-elasticity. The own pass-through rate is relatively unaffected by changes in ρ but is overshifted ≈ 1.3 and consistent with reduced-form estimates in Conlon and Rao (2020).

The point of Table C.2 is to show how the second-choice moments, in particular, help to identify a key parameter ρ, which governs our welfare predictions. One important caveat discussed in Section 5.3 is that we have "pseudo second-choice" data constructed by looking within a household's purchase history over time. This is not true second-choice data because we do not know a household that previously purchased *Smirnoff Vodka* which instead purchased *Skyy Vodka* did so because Smirnoff was unavailable, it may have been because the price went up, or because they have some love of variety. Berry and Haile (2024); Conlon and Gortmaker (2023) for a more technical discussion of micro-data and second-choices, and Conlon and Mortimer (2021) for how second-choice diversion measures related to small quality changes and price changes.

C.2.2. Allowing for Wholesaling Costs

We might worry that the main results are driven by our assumption that in the absence of post-and-hold policies, the wholesaler tier becomes perfectly competitive. A reasonable concern is that wholesaling is not costless, and unless wholesalers charge a markup above manufacturer prices, they may not be able to cover the costs of hiring drivers, and operating warehouses. To alleviate these concerns, we set $\mathbf{mc^w} = \mathbf{p^m} + 1$, so that the wholesaler incurs an additional cost of \$1 per liter both when estimating the demand model, and when computing the counterfactual. We think this is reasonable, as it is in line with the wholesaler margins on the lowest margin items.[91] The exercise is slightly different from Table 7 where we hold the parameter estimates fixed, and allow for a \$1/L wholesale margin.

Qualitatively, the patterns in Figure 8 in the main text and Figure C.3, which allows for the \$1 per liter wholesaling cost, are nearly identical. The relative ranking of various tax instruments,

[91]We obtain similar results if we consider larger wholesaling costs of $\mathbf{mc^w} = \mathbf{p^m} + 2$ or $\mathbf{mc^w} = \mathbf{p^m} + 3$.

Table C.1: Sensitivity to different values of nesting parameter ρ

ρ	Own	Agg	Lerner	Outside Good	Vodka	Gin	Rum	NA	UK	Tequila	Objective
0.05	-4.626	-0.622	0.239	0.577	0.476	0.162	0.272	0.250	0.212	0.169	5863.563
0.10	-4.662	-0.601	0.239	0.552	0.533	0.250	0.348	0.331	0.296	0.257	5813.226
0.15	-4.699	-0.579	0.239	0.526	0.585	0.331	0.418	0.405	0.371	0.336	5778.403
0.20	-4.738	-0.556	0.239	0.500	0.632	0.405	0.482	0.472	0.440	0.409	5758.438
0.242	-4.774	-0.535	0.238	0.477	0.668	0.463	0.532	0.524	0.494	0.466	5753.096
0.25	-4.781	-0.532	0.238	0.473	0.674	0.473	0.541	0.532	0.503	0.475	5753.305
0.269	-4.791	-0.524	0.238	0.465	0.690	0.499	0.563	0.556	0.525	0.501	5361.402
0.30	-4.826	-0.507	0.238	0.445	0.713	0.535	0.594	0.588	0.560	0.536	5763.204
0.35	-4.875	-0.480	0.238	0.417	0.748	0.591	0.644	0.638	0.612	0.592	5789.146
0.40	-4.927	-0.453	0.237	0.388	0.780	0.642	0.688	0.683	0.659	0.643	5832.463
0.45	-4.983	-0.424	0.237	0.359	0.809	0.689	0.729	0.725	0.703	0.689	5894.985
0.50	-5.043	-0.395	0.237	0.328	0.835	0.731	0.766	0.762	0.742	0.731	5978.927
0.55	-5.107	-0.363	0.236	0.298	0.859	0.770	0.800	0.796	0.778	0.770	6086.915
0.60	-5.175	-0.330	0.236	0.267	0.880	0.805	0.831	0.827	0.811	0.805	6222.142
0.65	-5.250	-0.296	0.235	0.235	0.900	0.837	0.859	0.856	0.841	0.837	6388.561
0.70	-5.332	-0.260	0.235	0.202	0.918	0.867	0.885	0.882	0.869	0.866	6591.177
0.75	-5.421	-0.222	0.234	0.170	0.935	0.894	0.908	0.906	0.895	0.893	6836.444
0.80	-5.519	-0.183	0.234	0.137	0.950	0.918	0.930	0.928	0.920	0.918	7132.864
0.85	-5.630	-0.141	0.233	0.103	0.964	0.941	0.950	0.948	0.942	0.942	7492.025
0.90	-9.526	-0.077	0.233	0.018	0.946	0.912	0.923	0.922	0.912	0.911	8602.323
0.95	-15.003	-0.076	0.233	0.011	0.974	0.957	0.962	0.962	0.957	0.956	10772.279

Note: We profile demand estimates by varying the level of ρ. This uses the (aggregate) demand moments, the (aggregate) supply moments, and micro-moments from NielsenIQ Panelist data.
Markups, own elasticity, and outside good diversion are unweighted averages over (j, t). Aggregate elasticity is the market-level reduction in purchase volume for a 1% sales tax averaged over markets. Pass-through is own $\frac{\partial p_j}{\partial c_j}$ (dollar for dollar) averaged over products in the final market.
Caution is required comparing GMM objectives across specifications since they have different weighting matrices.
Source: Authors' calculations

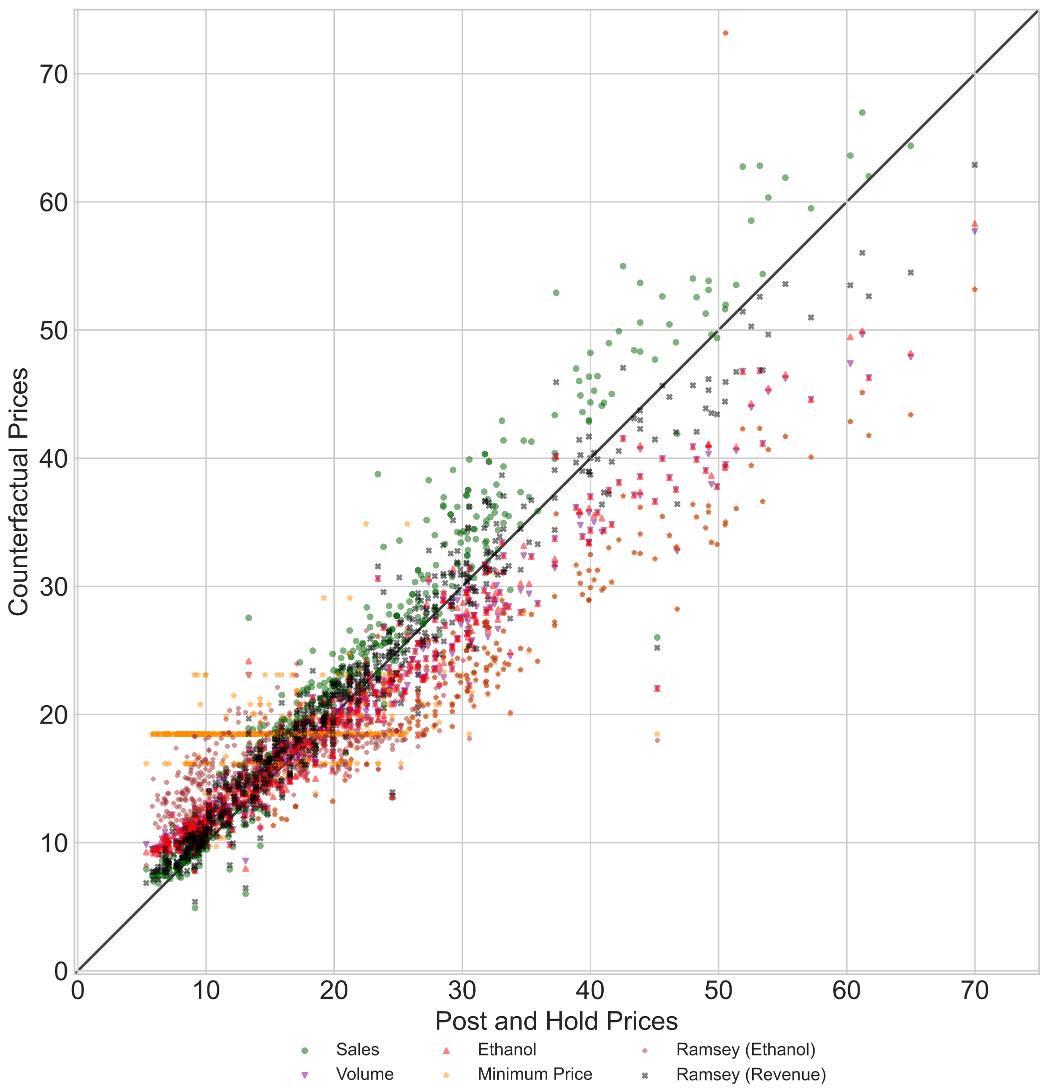
and most importantly, the fact that post and hold is clearly dominated by alternative taxes on a competitive market, remains the same. Quantitatively, the somewhat higher cost means that the overall level of additional tax revenue that can be generated is reduced slightly, such that we can never increase revenue by more than 250%. The resulting equilibrium prices are highly similar, the main difference being that rather than capturing all of that as additional tax revenue, some must be used to cover the wholesaler costs.

Table C.2: Distributional Impacts of Counterfactual Policies with $\mathbf{wc} = 1$

		% Change in CS					
No Change in Ethanol	% Total Revenue	% Overall	Below $25k	$25k-$45k	$45k-$70k	$70k-$100k	Above $100k
Ramsey (Ethanol)	7.1	27.8	5.1	4.3	0.2	15.6	40.7
Minimum Price	10.4	27.8	5.0	5.1	2.5	16.5	40.4
Ethanol	211.2	10.9	0.8	0.3	-0.2	4.8	16.6
Volume	214.3	10.1	-0.7	-2.0	-2.0	2.9	16.3
Sales+Volume	260.0	-0.9	-1.4	-2.1	-2.9	-2.7	-0.2
Ramsey (Revenue)	266.6	-3.7	-2.3	-2.6	-3.4	-4.8	-4.1
Sales	271.3	-8.8	-2.1	-1.7	-3.4	-6.6	-12.2
-10% Ethanol							
Ramsey (Ethanol)	33.6	17.9	-6.4	-13.0	-15.8	-1.5	33.2
Minimum Price	37.5	17.8	-6.5	-12.2	-13.9	-0.7	32.8
Ethanol	228.3	2.3	-9.3	-14.9	-14.4	-9.1	10.1
Volume	231.3	1.4	-11.0	-17.2	-16.3	-11.1	9.7
Sales+Volume	275.6	-10.4	-11.0	-16.4	-16.3	-16.0	-8.4
Ramsey (Revenue)	280.0	-13.0	-12.2	-17.2	-17.0	-18.0	-12.0
Sales	280.4	-17.7	-11.3	-15.5	-16.3	-18.9	-19.7
+10% Ethanol							
Minimum Price	-11.1	37.1	16.0	24.0	20.5	34.7	46.4
Ramsey (Ethanol)	-6.9	36.9	16.1	23.0	18.1	33.5	46.7
Ethanol	190.9	19.3	10.5	16.2	14.6	19.2	22.6
Volume	193.9	18.5	9.1	14.0	12.8	17.3	22.3
Sales+Volume	238.5	8.7	8.1	13.2	11.2	11.4	7.9
Ramsey (Revenue)	254.9	2.3	4.4	8.0	6.4	4.6	0.5
Sales	256.4	0.1	7.1	13.0	10.1	6.5	-4.7

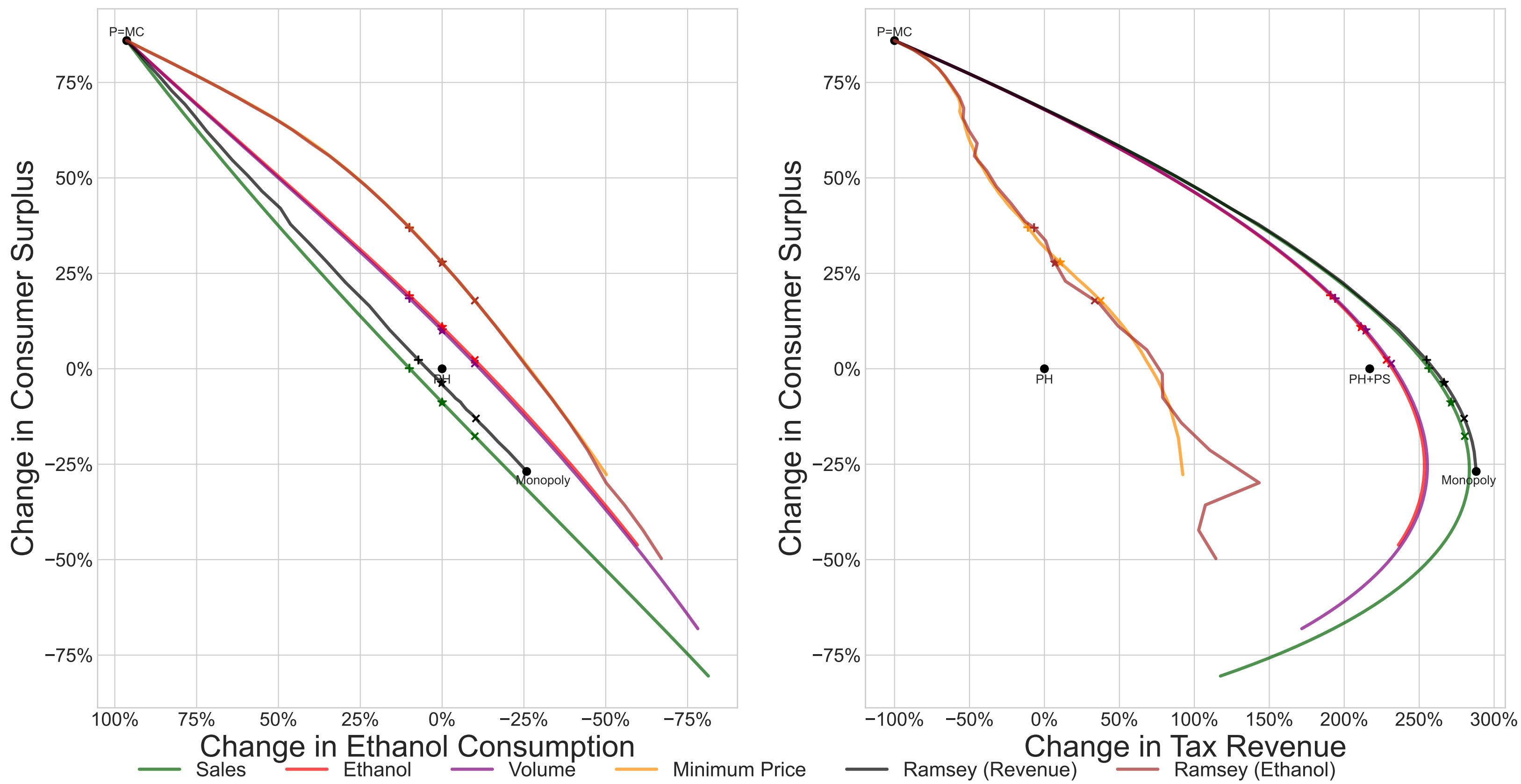
Note: The table above reports estimates of the impacts of the counterfactual policy alternatives described in Table 5 on tax revenue collected, overall consumer surplus, and the distribution of consumer surplus across the five income bins. All effects are reported as percentage changes relative to the PH baseline. The top panel describes the impact of alternative policies that limit ethanol consumption to the same aggregate level as under PH while panels B and C report the effects of alternative policies that reduce and increase ethanol consumption by 10%, respectively. Revenue is calculated as the additional tax revenue raised by the state compared to the existing excise tax collections.
Source: Authors' calculations

Figure C.2: Prices Under PH vs. Other Policy Alternatives with $\mathbf{wc} = 1$



Note: The figure above plots product prices under PH against prices under our counterfactual policy alternatives. In each of our counterfactual scenarios, we consider a tax rate that would keep the overall level of ethanol fixed at the status quo. Our taxes follow the definitions in Table 5, and are levied on a competitive market with a $1/L additional wholesaling cost. The solid black 45-degree line illustrates prices unchanged from PH.

Figure C.3: Consumer Surplus vs. Tax Revenue and Ethanol Consumption Under Alternative Policies with $\mathbf{wc} = 1$



Note: The figure above plots the change in tax revenue (left panel) and ethanol consumption (right panel) against the change in consumer surplus for each of the policy alternatives to PH detailed in Table 5 that we consider. The frontiers trace the trade-off between consumer surplus and tax revenue or ethanol consumption for each policy instrument. Stars indicate an aggregate ethanol consumption level equal to total ethanol under PH, while ($\times$) denotes 10% less and (+) denotes 10% more ethanol consumption (in the left panel higher ethanol consumption corresponds to less tax revenue). We also mark competitive prices without taxes (denoted by P = MC), and PH pricing. In the left panel, we indicate the revenue generated by existing excise taxes under PH pricing as well as the sum of tax revenue and wholesale profits generated by PH.

D. Panel Data Regressions

D.1. Cross-state Evidence on Consumption Effects of States Ending PH

Theory suggests that PH leads to higher markups, which is supported by the price comparisons detailed in Section 4.1. As such it is natural to expect that these higher prices may reduce aggregate alcohol consumption at the state level, which may be a policy objective.

To assess the impact of PH laws on aggregate alcohol consumption, we assemble a panel of annual state data measuring wine, beer, and spirits consumption, as well as demographic characteristics. These data are drawn from the National Institute on Alcohol Abuse and Alcoholism (NIAAA) *U.S. Apparent Consumption of Alcoholic Beverages*, which tracks annual consumption of alcoholic beverages for each state. We use the timing of when different states terminated PH laws (often as the result of lawsuits) to measure the association between regulation and alcohol consumption. Table D.1 reports PH termination dates. This table matches Cooper and Wright (2012), who also run a similar panel regression to the one we describe below (and obtain similar results):[92]

Table D.1: States with Post and Hold Laws

	Wine	Beer	Spirits
Connecticut	Y	Y	Y
Delaware	End 1999	End 1999	End 1999
Georgia	N	Y	Y
Idaho	Y	Y	N
Maine	Y	Y	N
Maryland	End 2004	End 2004	End 2004
Massachusetts	End 1998	End 1998	End 1998
Michigan	Y	Y	Y
Missouri	Y	N	Y
Nebraska	End 1984	N	End 1984
New Jersey	Y	Y	Y
New York	Y	Y	Y
Oklahoma	End 1990	End 1990	Y
Pennsylvania	N	End 1990	N
South Dakota	Y	N	Y
Tennessee	N	Y	N
Washington	End 2008	End 2008	N
West Virginia	N	N	Y

Note: The table above lists all states that have or have repealed PH regulations and details the types of alcoholic beverages covered by PH rules. Y denotes a state and beverage category with PH provisions. N denotes a state and beverage category was never subject to PH laws. The year of repeal is denoted for states that ended their PH regulations. No state adopted PH after the start of sample period, 1983. This table is a reproduction of Table 1 of Cooper and Wright (2012).

These state panel regressions are similar to those of Cooper and Wright (2012) and have the form:

$$Y_{it} = \alpha + \beta PH_{it} + X_{it}\gamma + \delta_t + \eta_i + \epsilon_{it} \tag{D.1}$$

[92] In contrast, Saffer and Gehrsitz (2016) find a null effect of PH on prices, but rely on ACCRA data which tracks the price of only one brand each for: beer (Budweiser 6-pack), wine (Gallo Sauvignon Blanc) and distilled spirits (J&B Scotch).

The dependent variable is the log of apparent consumption per capita, where consumption is in ethanol-equivalent gallons and the relevant population is state residents age 14 and older. PH_{it} is a dummy variable equal to one if state i has a PH law in place at time t; X_{it} is a vector of control variables; and δ_t and η_i are time and state fixed effects, respectively. The coefficient of interest, β, describes the reduction in alcohol consumption associated with PH laws.

We report the results in Table D.2. The specification of column 1 includes only time and state fixed effects while column 2 adds state-specific linear time trends. Accounting for state differences in underlying consumption trends attenuates the wine coefficient, rendering it statistically insignificant, but increases the magnitude and precision of beer and spirits coefficients and makes them statistically significant.

The identifying variation comes from the handful of states ending their PH requirement. There are a number of reasons we should remain cautious about taking the regression estimates too seriously. The first is that we don't know why states terminate PH, though in several cases it was the result of losing a lawsuit rather than through the legislative process. The bigger issue is that when states eliminate PH, they tend to also change tax rates, and liberalize other laws regarding the distribution and sale of alcoholic beverages. We may wrongly attribute other factors (ending prohibitions on Sunday sales, etc.) to eliminating PH.

Table D.2: Post and Hold Laws and State Alcohol Consumption

	(All)	(All)	(All)	(PH only)	(PH NE)
Wine					
PH	-0.0545***	-0.0215	-0.0197	-0.0277	-0.00360
	(0.0183)	(0.0192)	(0.0192)	(0.0182)	(0.0356)
R^2	0.965	0.984	0.984	0.985	0.988
Beer					
PH	-0.0155	-0.0218**	-0.0207**	-0.0192**	-0.0297**
	(0.0113)	(0.00968)	(0.00959)	(0.00859)	(0.0134)
R^2	0.891	0.968	0.968	0.954	0.980
Spirits					
PH	-0.00702	-0.0731***	-0.0725***	-0.0665***	-0.0851***
	(0.0175)	(0.0183)	(0.0181)	(0.0175)	(0.0279)
R^2	0.950	0.982	0.982	0.976	0.984
Year FE	Y	Y	Y	Y	Y
State FE	Y	Y	Y	Y	Y
State Time Trends	N	Y	Y	Y	Y
Demog. Controls	N	N	Y	Y	Y
PH States	N	N	N	Y	Y
NE States	N	N	N	N	Y
Observations	1,428	1,428	1,428	532	168

Note: The table above presents coefficients from regression equation D.1. The outcome of interest is the log of apparent consumption per capita, where consumption is in ethanol equivalent gallons and the relevant population is state residents age 14 and older. Column 1 only includes state and time fixed effects. Column 2 adds state-specific time trends while column 3 also includes state demographic controls. Column 4 limits the sample to states that have had PH laws. Column 5 restricts the sample further to only northeastern states that once had PH laws. The alcohol consumption data are from the National Institute on Alcohol Abuse and Alcoholism, which is part of the National Institutes of Health; the demographic information comes from the Census Bureau's intercensal estimates. Standard errors in parentheses.
*** p<0.01, ** p<0.05, * p<0.1

D.2. Cross-state Evidence on Employment and Establishment Effects of States Ending PH

Advocates for PH argue that the regulation benefits small retailers by ensuring that they pay the same wholesale prices as large retailers such as Costco or Total Wine and More.[93] If PH does indeed protect small retailers, PH states like Connecticut should be home to more small-scale retail establishments. The impact of PH on employment and the total number of establishments, however, is less clear. While under PH small retailers enjoy uniform pricing, these uniform prices are the higher prices that result from non-competitive wholesaler pricing behavior. Having more small retailers in a retail sector that faces lower margins due to high wholesale prices could lead to either more or fewer establishments that overall employ more or fewer workers.

Table D.3 provides some empirical evidence regarding these questions. The regressions presented in Table D.3 are of the same form as the estimation equation above, and describe the impact of PH spirits regulations on three different outcomes: share of small retail establishments, log employment in the liquor retail sector, and log liquor stores per capita.[94]

The uppermost panel of Table D.3 examines the impact of PH regulations on the prevalence of small liquor retailers (that is, establishments with between one and four employees). Column one uses only only data from 2010 and includes demographic controls—state population and median income—and finds a marginally significant positive relationship between PH and share of small liquor retail establishments. Columns two through four use the full panel from 1986 through 2010. Adding state and year fixed effects does not yield a significant coefficient, as shown by column two. Column three adds state-specific time trends, which control for changes in spirits consumption that vary by state. Adding these additional controls reveals that states with PH regulations do in fact have a larger share—4.8 percentage points larger—of small retail establishments. Dropping all states outside of the northeast does not substantively affect the coefficient but increases the precision of the estimate.

The middle panel examines the impact of PH regulations on employment in the alcohol retail sector. The dependent variable is the log of employment in the liquor retail sector per capita age 14 years and older. Looking at data from only 2010 does not suggest a statistically significant relationship between employment and PH laws. Adding year and state fixed effects as shown in column 2 reveals that states with PH laws actually have lower per-capita liquor retail employment. Including state time trends reduces the magnitude and precision of the coefficient from -1.762 (0.198) to -0.497 (0.239). Focusing on northeastern states (column 4) does not have an appreciable further impact on the estimates, though the estimate is less precise.

The bottom panel assesses how the number of establishments per capita is affected by PH regulations. As in the employment panel, examining the 2010 data alone does not suggest a statistically significant relationship between number of retailers and PH laws. Column two uses the full panel with state and time fixed effects, yielding a significant and negative coefficient. Controlling for state time trends reduces the coefficient to -0.608 (0.0914). As in the other panels, examining only northeastern states doesn't appreciably change the coefficient.

[93]For examples of complaints by small retailers, see https://www.thewesterlysun.com/wire_news/connecticut-s-liquor-law-faces-challenge/article_36891777-e489-56c4-b4f1-c761a30e0059.html

[94]Panel data describing state liquor retail establishment counts and employment come from the Census County Business Patterns for 1986 through 2010.

Table D.3: Post and Hold Laws and Alcohol Retailing

	2010 Only	All	All	Northeast
Share of 1-4 Employee Retailers	0.0728*	0.0339	0.0477*	0.0472**
	(0.0432)	(0.0209)	(0.0262)	(0.0227)
R-Squared	0.144	0.867	0.940	0.962
Log(Alcohol Employment/Pop 14+)	0.452	-1.762***	-0.497**	-0.422*
	(0.336)	(0.198)	(0.239)	(0.223)
R-Squared	0.064	0.467	0.740	0.821
Log(Liquor Stores Per Capita)	0.344*	-1.335***	-0.608***	-0.515***
	(0.204)	(0.0866)	(0.0914)	(0.103)
R-Squared	0.128	0.855	0.954	0.963
Obs	51	1,275	1,275	300
Demographic Controls	Y	Y	Y	Y
State FE	N	Y	Y	Y
Year FE	N	Y	Y	Y
State Specific Trends	N	N	Y	Y

Note: The table presents coefficients from regression equation D.1 where the outcome of interest is the share of retailers with 1-4 employees in the uppermost panel, the log of employment in the liquor retail sector per capita in the middle panel, and log of liquor stores per capita in the bottom panel. The reported coefficients correspond to a binary variable that is equal to one when spirits are subject to PH regulations. Column 1 uses only data from 2010 and includes demographic controls. Columns 2 through 4 use the full 1986 - 2010 panel. Column 2 adds state and year fixed effects. Column 3 adds state specific time trends and column 4 limits the sample to only northeastern states. Standard errors in parentheses.
*** $p<0.01$, ** $p<0.05$, * $p<0.1$