THE IMPACT OF PRIVATIZATION ON ALCOHOL CONSUMPTION AND STATE REVENUES

MONTGOMERY COUNTY PRESENTATION

The Sazerac Company

- American, family owned company
- Oldest operating distillery in the US (1783) and is a designated National Historic Landmark (Buffalo Trace Distillery in Frankfort, Ky)
- Very private and low profile
- 2500 total employees
- Largest manufacturer of distilled spirits in the United States
- Does business in all states and 50+ overseas markets
- Owns over 350 brands
- 7 U.S. manufacturing facilities, plus 1 in Canada.: Kentucky, South Carolina, Virginia, Louisiana, California, Maryland, New Hampshire, Maine and Puerto Rico.
- North American HQ based in Louisville, Ky
- 52 Bottling lines
- 70 million case production capacity (33% of total US market)
- 52 whiskey aging warehouses in the United States
- Owns inventory of 1,000,000 barrels of aging whiskey, 180 million bottles

WHAT WE BELIEVE

- Alcohol is a unique product whose position in global society requires careful management, well thought out and executed regulatory regimes. Or, Captain Morgan is not Captain Crunch.

- The 21st amendment has succeeded in its purpose to reintegrate alcohol into American society in the least impactful way and, while not perfect, its resulting system of state-based government controls, regulations, three tier and control state systems continues to this day to protect American society while providing a competitive marketplace for alcohol with low barriers to entry.

- We are a STRONG SUPPORTER of the three tier system.

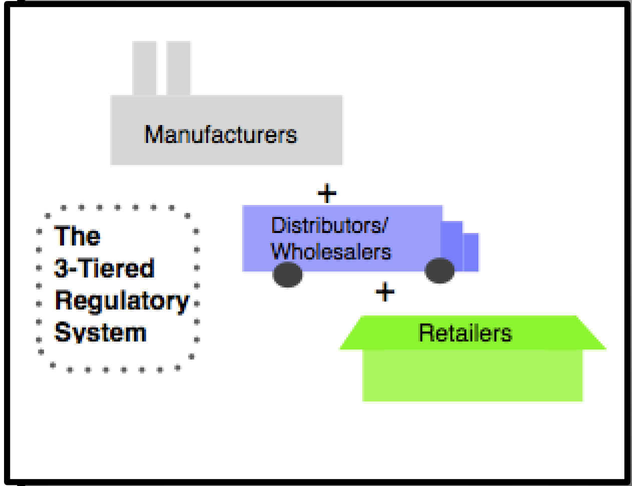
- By contrast, poor alcohol management policies in many other parts of the world underscore the potential adverse consequences for any given society. Intelligent management of alcohol in society is paramount to minimizing potential costs and consequences to society.

- Access to alcohol needs to limited.

- Deregulation has <u>consistently</u> led to an increase in underage drinking, binge drinking among adults/the underaged, crime, serious health consequences.

Three tier system challenges

- U.S. three-tier system has unique values in balancing the market, collecting taxes and product safety. All alcohol moves through 3 licensed tiers.
- Middle tier is a buffer and prevents market domination by suppliers or retailers. Market domination usually leads to aggressive sales practices inducing vulnerable populations to buy more alcohol.
- Price measures at wholesale and retail level rated highly effective in recent research journal.
- Many threats to three-tier system including legislative changes, court suits and ballot measures.
- States also have less resources for enforcement, more alcohol outlets, and in some places there are substantial violations of wholesale regulations.



"Those who cannot remember the past are condemned to repeat it."
George Santayana, Reason in Common Sense

- THE GREAT BRITAIN EXPERIENCE

- There is currently an epidemic of alcohol abuse in Great Britain.

- They should know better because it has happened numerous times before and all as a result of deregulation.

- The Gin Craze: In the 1700s, laws were changed to help the gin industry and increase gin consumption. The tax was decreased, which made it an attractive product versus beer. Consumption quickly rose and huge problems ensued. For almost a decade, Brits tried to get the problem under control, mostly via major tax hikes. The high taxes were initially ignored, but eventually a balanced tax and campaign against spirits took hold. But it took over 100 years.

- World Wars: When the First World War commenced, drinking was again very heavy and England realized it could lose more people to alcohol than to the war. At that point, the government instituted tight controls over drinking hours and places, and encouraged people to drink a weak beer product. These strategies worked well – so well that they were retained and loosened somewhat. During the Second World War, tight control was again instituted and mostly retained after the war.

GREAT BRITAIN, CONT.

- The slippery slope of deregulation: Alcohol was allowed to be sold in retail stores in the 1960s; bar and pub closing hours were extended, as were Sunday sales. After 2003, 24-hour sales were allowed. Drinking laws for youth were very weak and there was little enforcement. Large increases in alcohol disease and hospitalization occurred.
- The UK has been engaged in numerous attempts to quell the problems. Some of these attempts may eventually work, but a mere review of their history could have told them that when you loosen regulations, problems ensue.

"If you build it, they will come." --Field of Dreams

- Research has consistently shown that is the case with facilities that sell alcoholic beverages. The more stores there are, the more alcohol that is sold – with its attendant increase in drunken driving, underage consumption, addiction and crime.

- In England today, alcohol is available in bars, clubs and grocery stores 24 hours a day, seven days a week. This "convenience channel" contributed greatly to excess drinking.

- Supermarkets, in particular, profited from the new regime. They were free to stock wine, beer, and liquor alongside other consumables, making alcohol as convenient to purchase as marmalade. They were free, also, to offer discounts on bulk sales, and to use alcoholic beverages as so-called loss leaders, selling them below cost to lure customers into their stores and recouping the losses through increased overall sales. Very quickly, cheap booze became little more than a force multiplier for groceries.

- Four large grocery chains control 75 percent of the market. Again, most use alcohol as a loss leader, as they engage in price wars.

- Relative to disposable income, alcohol today costs 40 percent less than it did in 1980.

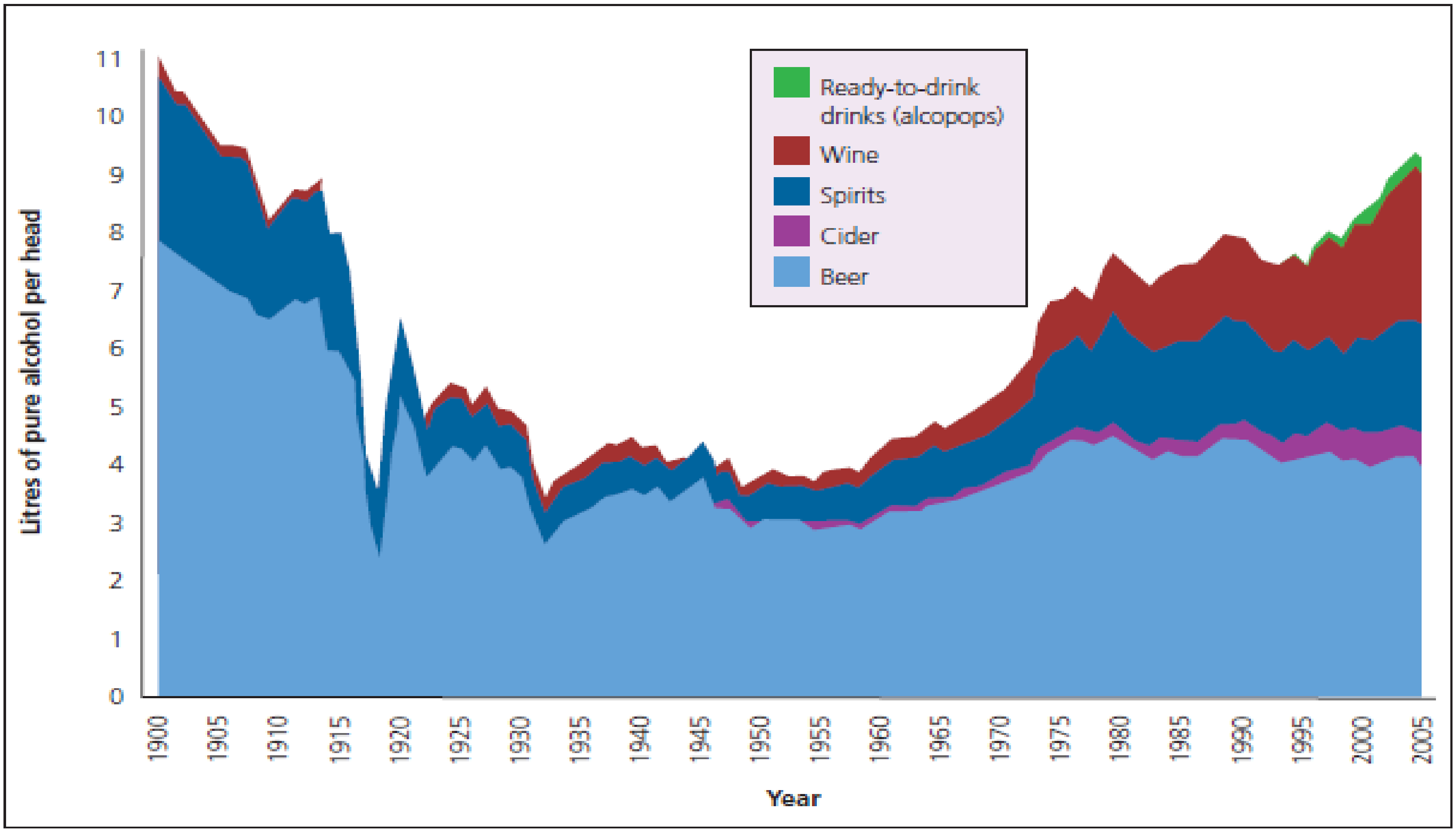
RESULTS

- Since the 1970s rates of cirrhosis and other liver diseases among the middle-aged have increased by eightfold for men and sevenfold for women.

- Since 1990, teenage alcohol consumption has doubled. Since World War II, alcohol intake for the population as a whole has doubled, with a third of that increase occurring since just 1995. The United Kingdom has very high rates of binge and heavy drinking, with the average Brit consuming the equivalent of nearly 10 liters of pure ethanol per year.

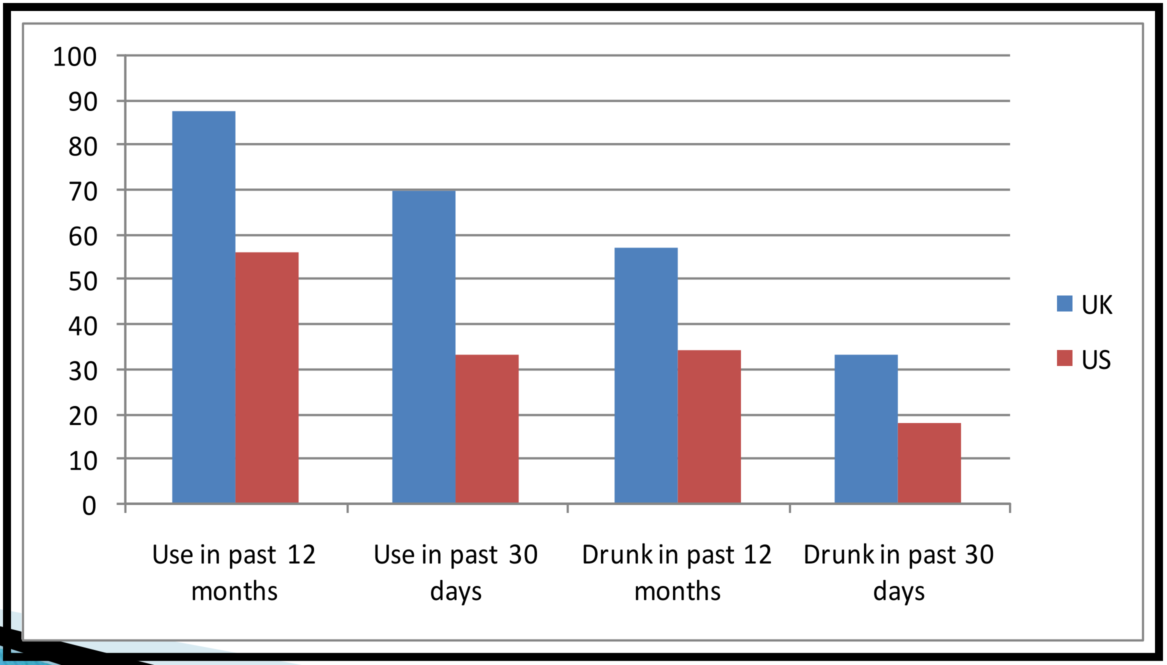
UK deregulation begins in the 1960s; increased consumption and problems follow in the wake

- Source: Statistical handbook 2007 (British



Youth are drinking at twice US rates!

- Drinking and intoxication of youth 15-16 are at very high rates, according to the European School Survey.



HOW DOES THE US COMPARE?

- The United States, although no stranger to alcohol abuse problems, is in comparatively better shape. A third of the country does not drink, and teenage drinking is at a historic low. The rate of alcohol use among seniors in high school has fallen 25 percentage points since 1980.

- However, we still have problems. According to the Centers for Disease Control and Prevention, excessive alcohol use was attributed in:

. approximately 80,000 deaths each year in the United States.

Each year, approximately 5,000 people under the age of 21 die as a result of drinking

. more than 1.2 million emergency room visits and 2.7 million physician office visits in 2006.

. 2.3 million years of potential life lost (YPLL) annually, or an average of about 30 years of potential life lost for each death.

. economic costs of excessive alcohol in 2006 estimated at $223.5 billion.

US…continued

- Why has the United States, so similar to Great Britain in everything from language to pop culture trends, managed to avoid the huge spike of alcohol abuse that has gripped the UK? The reasons are many, but one stands out above all: the market in Great Britain is rigged to foster excessive alcohol consumption in ways it is not in the United States—at least not yet.
- Monopolistic enterprises control the flow of drink in England at every step—starting with the breweries and distilleries where it's produced and down the channels through which it reaches consumers in pubs and supermarkets. These vertically integrated monopolies are very "efficient" in the economist's sense, in that they do a very good job of minimizing the price and thereby maximizing the consumption of alcohol.
- What prevents the US from becoming Great Britain?

THE 21st AMENDMENT

- The 21st Amendment grants state and local governments express power to regulate liquor sales within their own borders. Thus, the existence of dry counties and blue laws; of states where liquor is only retailed in government-run stores, as in New Hampshire; and of states like Arkansas where you can buy booze in drive-through liquor marts.

- More significantly, state and local regulation also extends to the wholesale distribution of liquor, creating a further barrier to the kind of vertical monopolies that dominated the United States before Prohibition and are now wreaking havoc in Britain.

- Since the repeal of Prohibition, such constraints on vertical integration in the liquor business have also been backed by federal law, which, as it's interpreted by most states, requires that the alcohol industry be organized according to the so-called three-tier system. The idea is that brewers and distillers, the first tier, have to distribute their product through independent wholesalers, the second tier. And wholesalers, in turn, have to sell only to retailers, the third tier, and not directly to the public. By deliberately hindering economies of scale and protecting middlemen in the booze business, America's system of regulation was designed to be **willfully inefficient**, thereby making the cost of producing, distributing, and retailing alcohol higher than it would otherwise be and checking the political power of the industry.

IN DEFENSE OF CONTROL STATES

- Professor Ronald Zullo, an economist from the University of Michigan recently completed one of the only comprehensive reviews of control state revenues vs. private state revenues. He studied alcohol monopoly systems with regard to four topics: alcohol consumption, state finances, alcohol related auto fatalities, and crime. Here are the highlights from his findings:

- State monopolies have the potential to generate 2-3 times the alcohol-related income than private license systems do.

- Alcohol monopolies generate relatively more alcohol-related revenues. Alcohol revenue comes from alcohol taxes, liquor licenses, and sale of alcohol products. State monopolies get income from all three sources; license states get only taxes and license income. Thus, it stands to reason that monopoly states would receive higher alcohol-related income. But, it is a major difference: the gain can be 82.4% more if the state only owns the wholesale operation and 90% if it also owns the retail system.

- Under Montgomery County's current system, the county has more buying power than big box chain stores. It helps keep costs down and allows more brands to be purchased.

- Studies show that states are a more responsible seller of alcohol which leads to fewer DUI's and fewer problems associated with over consumption.

Professor Zullo, cont.

State ownership equates with lower wine and spirits consumption. In monopoly states, spirits consumption is 11.9 to 15.1 percent less than in license states, and wine varies from 61.0 percent less to 9.9 percent less, depending on the control model.

Days and hours of retail operation did not appear to affect wine and spirits consumption. States that give municipalities a local option for retail hours, however, had a 1.7% increase in sales.

Alcohol monopolies generate substantial alcohol-related revenues. States that own wholesale receive about 82.4 percent higher alcohol-related revenue than license states. When states own retail as well, the per capita revenue is approximately 90 percent higher than license states. In general, as the strength of the state alcohol monopoly system increased, so did alcohol related revenues for state coffers. So improve the system, don't dismantle it.

PROFESSOR Zullo, cont.

The most lucrative organizational arrangement was where the state owned wholesale, and relied on a network of state-owned and agency retail outlets, with the state stores located in high traffic regions, and the agency stores in less-populated areas. These optimal monopoly models generated an average of $71.00 in alcohol-related revenues per capita, compared with an average of $24.91 for license states.

Monopoly states that did divest from retail stores from the 1980s through the 1990s did not gain financially, and may have suffered a loss. States that divested and managed to retain alcohol-related income did so by controlling wholesale and instituting new sales taxes. Even with theses policy changes, however, it does appear that strong monopoly states (states that did not divest from retail) recovered faster from the 1980s recession than weak monopoly states.

Revenues from alcohol sales, taxes and licenses in monopoly states are often ear marked for specific uses, such as law enforcement or substance abuse treatment programs. Otherwise, these funds become contributions to state or local general accounts and are used to finance other public services.

Professor Zullo, Cont.

- Weak alcohol monopolies (wholesale only) were associated with the highest percent of alcohol-related vehicular fatalities. When the effect of retail is isolated, the findings imply that state ownership of retail reduces alcohol-related vehicular fatalities. State ownership of retail was associated with 7.3 to 9.2 percent lower alcohol-related vehicular fatalities per capita and 6.5to 7.5 percent lower alcohol-related vehicular fatalities per vehicle traffic mile. These findings held even after adjusting for per capita alcohol consumption. A third metric, the ratio of alcohol related fatalities to total fatalities was statistically insignificant.

- Having a dram shop law was associated with a 5.1 to 7.9 percent decline in alcohol related vehicular fatalities. Stiffer penalties for DWI convictions were not associated with lower vehicular fatality rates. The findings underscore the importance of regulating transactions at the point of sale in order to encourage responsible alcohol consumption.

- Of the twenty-three crime categories tested, state control over retail is associated with lower per capita rates of crime for aggravated assaults, fraud, domestic abuse, and vandalism. Results from a less stringent statistical test also suggest that vehicle theft, arson, and vagrancy are lower when the state owns retail stores.

Professor Zullo, Cont.

- Restrictions on non-Sunday off-premise retail sales hours are generally associated with lower crime in the following categories: aggravated assault, drunkenness, and vagrancy, but higher for disorderly conduct. Sunday hours restrictions are associated with lower rates of theft and curfew violations, but higher fraud and embezzlement.

- For on-premise retail (e.g. restaurants, bars, etc.), a dram shop law was associated with lower rates of vehicle theft and drunkenness, and with higher rates of rape, theft (non-vehicle), burglary, liquor law violations, DWI, sex offences and vandalism. Restrictions on non-Sunday hours are associated with reduced rates of murder, aggravated assault, robbery, vagrancy, fraud, and embezzlement. However, several crime rates are higher with more restricted Sunday hours, including murder, aggravated assault, arson, embezzlement, and disorderly conduct.

Professor Zullo, Cont.

- In sum, state alcohol monopolies have the potential to generate two to three times the alcohol-related revenue as states with a private license system. Most of this gain is through state ownership of wholesale spirits distribution. Judged by finances alone, state ownership of retail provides an incremental gain to the states. The more valuable advantage in state ownership of retail is a reduction in alcohol-related social harm, especially alcohol-related vehicular fatalities and some types of crime. States that divested from ownership of the alcohol retail sector since the late 1970s did not improve their financial performance. Moreover, the privatization of retail alcohol outlets likely exacerbated alcohol-related harm.

PRIVATIZATION IN ACTION

- No control entity like Montgomery County has been able to keep alcohol prices lower while at the same time providing more consumer choice.

- On top of that, the last 3 states that have implemented privatization have all resulted in higher consumer prices, less choice and less revenue for state coffers. They are : Washington, Iowa and West Virginia.

WASHINGTON STATE AND PRICE

- Privatized in 2012 as a result of a statewide referendum led by large grocery stores who contributed roughly $25 million to the winning campaign.
- Legislation greatly favored volume sellers. This means small retailers are driven out of the market place over time.
- Prices rose 11 to 25%.
- In Washington, 2 years after privatization, The Seattle Times reported that the average cost of a liter of liquor, after tax, stands at $24.39, up from $21.19 before privatization took effect. The Tax Foundation found Washingtonians pay $35.22 per gallon of spirits, $8.52 more than before privatization and by far the highest in the nation.
- Border sales increased 35 to 60%.
- Outlets went from 329 to 1680. Hardware stores can sell alcohol.
- By 2015, roughly 40% of those stores have gone out of business because they could not compete with big box stores. That has risen to upwards of 60% in 2016.

Washington and Choice

- Not surprisingly volume went up as consumers traded to the cheaper brands and larger bottles.
- This becomes a race to the bottom by small outlets in order to compete.
- While supporters of the initiative promised lower prices and more choice, consumers got neither. 3 years after privatization, the state sold of its monopoly where it controlled prices and kept the profit. In return, they now have a duopoly where 93% of the market is controlled by 2 national companies.
- Likewise, the retail market is now dominated by large box stores, who spent over $20 million pushing the privatization initiative (they accounted for 99.5% of all contributions). That was money well spent. Out of the top 20 selling liquor stores in Washington, 16 of them are owned by big box stores. The other 4 are also large stores located in primarily urban areas.
- When mom and pop liquor stores are forced to close, consumers get less choice. Big box chains only carry a select number of brands in each category, and they are almost always national brands.

Washington and Social Impacts

- The average of 17 independent studies on the impact of privatization on consumption showed an increase of more than 40 percent in sales of privatized alcoholic beverages.
- Teen drinking and shoplifting have increased significantly. Why?
- High school students interviewed for The Olympian investigation said it's easy to steal bottles of hard liquor from grocery stores, because "you're not an automatic suspect when you walk in a grocery store."
- Individual stores reported losing as much as $30,000 to $50,000 in the first 3 months of privatization.

Washington and Revenues

- I hear the argument around the country that if alcohol were just more convenient to buy, then the state would see increased revenues. Washington increased their retail stores 5 fold, but 2 years after privatization, their alcohol revenues are down.

- Why? Price is largest driver of sales, not convenience. Half of your residents do not purchase alcohol, so generally you are not creating new customers, just repeat customers. Those customers will trade down to value brands if prices rise too much.

- Revenue generated from liquor sales spiked in the first full in Washington, the year the initiative took effect, to $521 million, up more than $70 million from the year before. But much of that money came from one-time fees, totaling more than $100 million. In 2014, the state had collected a little more than $400 million in revenue.

Iowa

- In fiscal year 1986, the last full year before privatization, $71.6 million was sent to the state after expenses, according to Tonya Dusold, a spokeswoman for the Iowa Alcoholic Beverages Division relying on prior year's records. In fiscal year 1988, the first full year after privatization, $46.3 million was sent to the state, according to Dusold. It took Iowa until 2004 to reach pre-privation levels

- Senate Republican Leader Mike Gronstal, who helped push privatization through the Senate, said legislators constantly touted the possibility of a massive windfall. "If you wanted to sell off everything, there was a potential for millions," he said. "But there was some real fear about losing the annual money."

- Money from liquor sales to the state for the general fund, substance abuse treatment and prevention, marketing and aid to localities dropped considerably after privatization.

- Iowa chose not to privatize the wholesale portion of the liquor pipeline because the state stood to lose $60 million to $70 million each year if it did, said former House Speaker Don Avenson, a Democrat who strongly supported the bill.

Source—Washington Post

WEST VIRGINIA

- In West Virginia, during fiscal year 1990, the last full year before privatization, $9.7 million was sent to the state after expenses, according to Kimberly Osborne, a spokeswoman for West Virginia Department of Revenue relying on prior year's records. In fiscal year 1992, the first full year after privatization, $6.6 million was sent to the state after expenses.

- Each state made less than $20 million upfront when they privatized. Officials there said the change helped them become more efficient and saved overhead costs, but never produced the anticipated windfall.

Source—Washington Post

SUGGESTIONS

- The Maine model: Maine had a massive healthcare shortfall. In response, they released an RFP for their wholesale operations as collateral for a $220M revenue bond.
- State expects to receive $450M over ten years from the winning bidder. Received $46M the first year. Previous contract only got them $190M over 10 yrs.
- How did they do it?
- The winning bidder owns and manages the warehouse, employees, trucking and back office operations.

MAINE, Cont.

- Prices do not go up because the state sets the retail price. They are an agency system so they set prices and mark ups.
- Private wholesaler gets an agreed up 4.7% profit.
- No profit sharing if more money is brought in, but you can put in an incentive bonus.
- Wholesaler does not pay for inventory, that cost is born by manufacturers in the form of a bailment fee.
- Wholesaler covers operating costs, <u>not</u> carrying costs.

SUGGESTIONS, Cont.

- Agency model
- JOBS OHIO
- Virginia Authority
- Minimum pricing
- Increase outlets by a reasonable measure
- No private label
- Limit number of superstores

It Just Doesn't Add Up

- Privatization is bad for county coffers.
- You get less tax revenue and more problems associated with increased drinking.
- Increased prices means you will lose sales to border states but the problems associated with alcohol you get to keep.
- Customers get higher prices and fewer choices.
- You trade a government monopoly for a private one where the government and its citizens have less influence when problems arise (and they will).

Lessons

- Regulatory changes should be made very carefully in order to avoid increasing the harm of alcohol misuse. One should attempt to assess potential harms from the change, but recognize you can't predict everything.
- Once deregulation sets in, it may be impossible to reverse the changes; and the social problems may take a long time to reduce.
- However, we must be flexible and willing to change to accommodate new circumstances and legitimate business needs.
- A balanced market is good for public safety and for your county's business environment. Such a market allows large, small, local and international companies to be reasonably successful.