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Initiatives 1100 and 1105: Ending the State's Liquor Monopoly

Briefly

While state government has a legitimate interest in liquor regulation, the distribution and retail sale of distilled spirits is not an essential state activity.

Now, facing a $4.5 billion state budget shortfall, looming public employee pension obligations and a growing recognition that state government must sharpen its focus on priority responsibilities and core functions, the time has come for privatization.

I-1100 represents a cleaner form of privatization than I-1105, which preserves the state's unnecessary intrusion into liquor distribution.

Two initiatives on the fall ballot, I-1100 and I-1105, would profoundly alter the state's liquor distribution and retailing system. While both would generally privatize the market for spirits by closing state-run liquor stores and establishing a licensing system for the distribution and retail of spirits, the two initiatives differ crucially with respect to the contours of the new system they would establish and (potentially) their impacts on state revenues.

Background

The repeal of Prohibition forced individual states to revisit the question of the proper role of government in regulating the sale and consumption of alcohol. Despite the widely acknowledged failure of Prohibition, the promotion of temperance was still seen as a legitimate function of the state. In the words of Alfred J. Schweppe—former University of Washington Law School Dean and architect of the liquor control system adopted as the Steele Act of 1933—the state should encourage temperance by "limiting so far as humanly possible the promotion and sale of intoxicants of heavy alcoholic content." Washington, like many other states, saw a government monopoly on the sale and distribution of spirits and the strict regulation of the market for beer and wine as the best way to achieve that goal. While many of the laws passed in the aftermath of Prohibition have been changed—bars may serve spirits by the glass and blue laws have been repealed—the vestiges of the pro-temperance system remain in the continued government monopoly.

Under the current system, the government owns the only liquor distribution center in the state, which distributes liquor to 160 state-owned liquor stores and 155 contract stores (contract stores primarily serve rural areas). The state receives revenue by imposing a 51.9 percent markup on all spirits sales and taxing these sales at a rate of 20.5 percent plus $3.77 per liter. The combination of the markup and per liter tax results in an effective tax rate of $25.73 per gallon, the highest rate in the nation (Oregon has the next highest rate, at $20.76 per gallon; New Hampshire, Wyoming, and Vermont, at the opposite end of the spectrum, do not tax spirits). The state collected $332.7 million in markups, taxes, and fees in FY 2009, with approximately 60 percent of that total coming from taxes. The state allocates this revenue to the state's General Fund (about 60 percent), cities and counties (about 19 percent), health services (about 16 percent), education and prevention (about 6 percent), and research (0.5 percent).

As mentioned, the state also maintains restrictions on the distribution and retail sale of beer and wine, and these restrictions are germane to the two current initiatives. The state has designed what is known as a three-tier system, where manufacturing, distributing, and retailing exist as separately licensed activities. This system prohibits manufacturers and distributors of beer and wine from possessing a financial interest in retail businesses (with some limited exceptions). The division between manufacturers and distributors is not so strict, as

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manufacturers may own a distributor. A buffer, however, does exist between manufacturers and distributors, as manufacturers must offer a uniform price to all distributors. Further measures prohibit manufacturers or distributors from offering bulk discounts to their customers. With this overview of the current system in mind, it is possible to understand the changes proposed by the two initiatives.

I-1100

Estimated Revenue Loss

	FY 2011–FY 2015	
	State	Local
1100	$76–$85	$179–$192
1105	$486–$520	$205–$210

Source:OFM

I-1100 would end the state's monopoly on the distribution and retail sale of spirits, forcing the state to close its distribution center and employee-operated stores by December 31, 2011. Instead, the Liquor Control Board would be authorized to issue general liquor distributor and general liquor retail licenses, holders of which would be permitted to distribute and sell beer, wine, and spirits. Grocery and specialty stores that currently sell beer or wine would be automatically granted a general liquor retail license, while current distributors of beer and wine would similarly be granted general liquor distributor licenses. General liquor retail licenses would be available beginning June 1, 2011 and distributor licenses from January 1, 2011. Further, the initiative would abolish the current three-tier system, eliminating the separation imposed on manufacturers, distributors, and retailers and ending the prohibition on bulk discounts.

I-1100 would thus end the state's monopoly on spirits, incorporate spirits into the beer and wine distribution and retail system, and end some of the regulations governing that system. While eliminating the state's profits from its markup on spirits, I-1100 preserves existing taxes on their sale. The state's Office of Financial Management (OFM) has presented estimates of the costs to state and local governments in lost revenue based on the size of the total private distributor/retailer markup, the increase in consumption as a result of changes in access and prices, and the number of licensed distributors and retailers. According to these estimates, state revenue would decrease by between $76 million and $85 million over five years (2011–2015) while local governments stand to see revenue decrease by between $179 million and $192 million. OFM's analysis, however, does not include revenue that cities with B&O taxes would collect on liquor sales.

A report released by the state auditor in December of 2009 anticipated an *increase* in state revenues of approximately $87 million in a privatization scenario akin to the one proposed by I-1100 (the report did not refer to I-1100 specifically). While the complete methodologies of the two reports are not available, the discrepancy seems largely due to: 1) an assumed private sector markup five percentage points higher (yielding a larger taxable base) in the auditor's report than the largest markup scenario envisioned by OFM and 2) an estimated increase in liter spirits sales due to privatization of 14.7 percent in the auditor's report as compared to 5 percent in OFM's report.

Initiative I-1105

Initiative 1105 proposes similarly large changes to the current system. It would shut down the government's spirits monopoly, forcing government liquor stores to close by April 1, 2012, and replace it with a completely private distribution and retail system. The Liquor Control Board would again be responsible for establishing and issuing distribution and retail licenses, though I-1105 does not contain the "automatic upgrade" language of I-1100 for current distributors and retailers. Successful license applicants could begin selling spirits on November 1, 2011. Unlike I-1100, however, I-1105 will not end the current three-tier system separating manufacturers, distributers, and retailers, requiring retailers of spirits to make their purchases from distributors. The one exception I-

1105 will introduce to the three-tier status quo is that it will permit bulk discounts on spirits (but not beer or wine).

While more or less maintaining the three-tier system, I-1105 could change the state's revenue situation considerably. In addition to eliminating the state's markup profits, I-1105 will eliminate all existing taxes on the sale of spirits. In their place, it imposes a 6 percent tax on retailers' gross annual spirits sales and a 1 percent tax on distributors' gross annual spirit sales. Both of these taxes expire after five years. Additionally, the Liquor Control Board must propose—by January 1, 2011—a plan to tax spirits sales at a per-liter rate that will generate revenues for state and local governments equal to the revenues under the current system plus an extra $100 million over five years. The legislature may adopt this plan at its discretion. OFM has estimated the revenue impact of I-1105 according to the same assumptions it used for I-1100, with the addition of I-1105's tax on retailers and distributors. The estimates do not include any additional tax that may be imposed as a result of the Liquor Control Board's recommendation to the legislature. Under these assumptions, OFM estimates that state revenues will decrease by between $486 and $520 million and local revenues will decrease by between $205 and $210 million. No alternative estimates exist, as the previously mentioned report from the auditor did not include a proposal comparable to I-1105.

Discussion

Washington is one of 18 states designated a "control" state by the National Alcoholic Beverage Control Association (NABCA). Considerable heterogeneity exists among these states, so economists Antony Davies and John Pulito have developed a classification system that divides control states based on the extent of control of retail and distribution. Heavy control states control the distribution of at least one kind of alcohol (from among beer, wine, and spirits) and the retail of at least two. Washington is a moderate control state, where the distribution of at least one type of alcohol is controlled, as is the retail of exactly one type. Finally, light control states have fully privatized retail sales but maintain control of at least one type of alcohol at the distribution level. In contrast to the control states, 32 "license" states leave the distribution and retail sale of alcohol to the private sector. I-1100 would thus convert Washington to a license state, while Initiative 1105, by maintaining current controls on distribution, would change Washington from a moderate control to a light control state. Several other states have moved from greater levels of control to lesser levels (Iowa and West Virginia, for example, ended control of retail sales about 20 years ago), but no control state has become a license state. In this regard, I-1100 represents a more complete break with the past, whereas I-1105 follows in the footsteps of several other states.

NABCA Control States

	Degree of Control		
	Full	Moderate	Light
Alabama		X	
Idaho		X	
Iowa			X
Maine	X		
Michigan			X
Mississippi			X
Montana	X		
New Hampshire		X	
North Carolina		X	
Ohio		X	
Oregon		X	
Pennsylvania	X		
Utah	X		
Vermont		X	
Virginia		X	
Washington		X	
West Virginia			X
Wyoming			X

Source: Pulito and Davies

The appearance of both of these initiatives on the ballot presents the possibility of both passing. Should that happen, it is unclear what precisely would ensue. Unlike some other states, Washington law does not have a provision that gives precedence to the initiative that passes with the most votes. A formal opinion by the Attorney General's office regarding another case of conflicting initiatives (601 and 602 in 1993) stated that the legislature could resolve any conflict via a two-thirds vote amending one or both initiatives. If the legislature does not act, it would fall to the courts to resolve the issue.

Supporters of both initiatives tout the benefits privatization will bring in terms of price, selection, and convenience. Backers of I-1100 also point to the elimination of the requirement that retailers purchase from distributors and the ending of the ban on bulk discounts as pro-consumer measures. Some debate exists over the impact these two provisions would have on small retailers and producers. Proponents of I-1100 claim that despite the fact that large retailers such as Costco will undoubtedly benefit from bulk discounts, the elimination of distributor middle-men will benefit small producers who currently have trouble convincing large distributors to carry their products.

Opponents of the initiatives voice concerns over their impact on state revenues. While OFM estimates large revenue losses from both initiatives, I-1105 proponents argue that the state will actually gain revenue if it adopts the initiative-mandated proposals developed by the Liquor Control Board. Backers of I-1100 argue, on the other hand, that the cost to the state is a relatively small price to pay for curbing government intrusion into the liquor market.

Opponents also claim that making liquor cheaper and more widely available could lead to increases in drunk driving, under-age drinking, and alcohol abuse. Supporters, however, point to statistics indicating that there is no meaningful difference between monopoly and license states in this regard and claim that getting the Liquor Control Board out of the distribution and retail business will enable it to focus on its enforcement and education missions.

In assessing the two initiatives, we also consider the questions Gov. Gregoire is asking as part of her "transforming Washington's budget" exercise this summer and fall. Her first question in particular is pertinent:

> *Is the activity an essential service?*

While state government has a legitimate interest in liquor regulation, the distribution and retail sale of distilled spirits is not an essential state activity. Liquor privatization has been discussed for years. And for years, it would have made sense for the state to get out of the business. Now, facing a $4.5 billion budget shortfall, looming pension obligations for public employees, and a growing recognition that state government must sharpen its focus on priority responsibilities and core functions, the time has come for privatization.

That leaves only the question of which initiative offers the better privatization model. Initiative 1100 would put Washington into the mainstream, closer to the successful practice in 32 license states that leave distribution and sales to the private sector. In that way, it represents a cleaner form of privatization than I-1105, which preserves the state's unnecessary intrusion into liquor distribution.

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