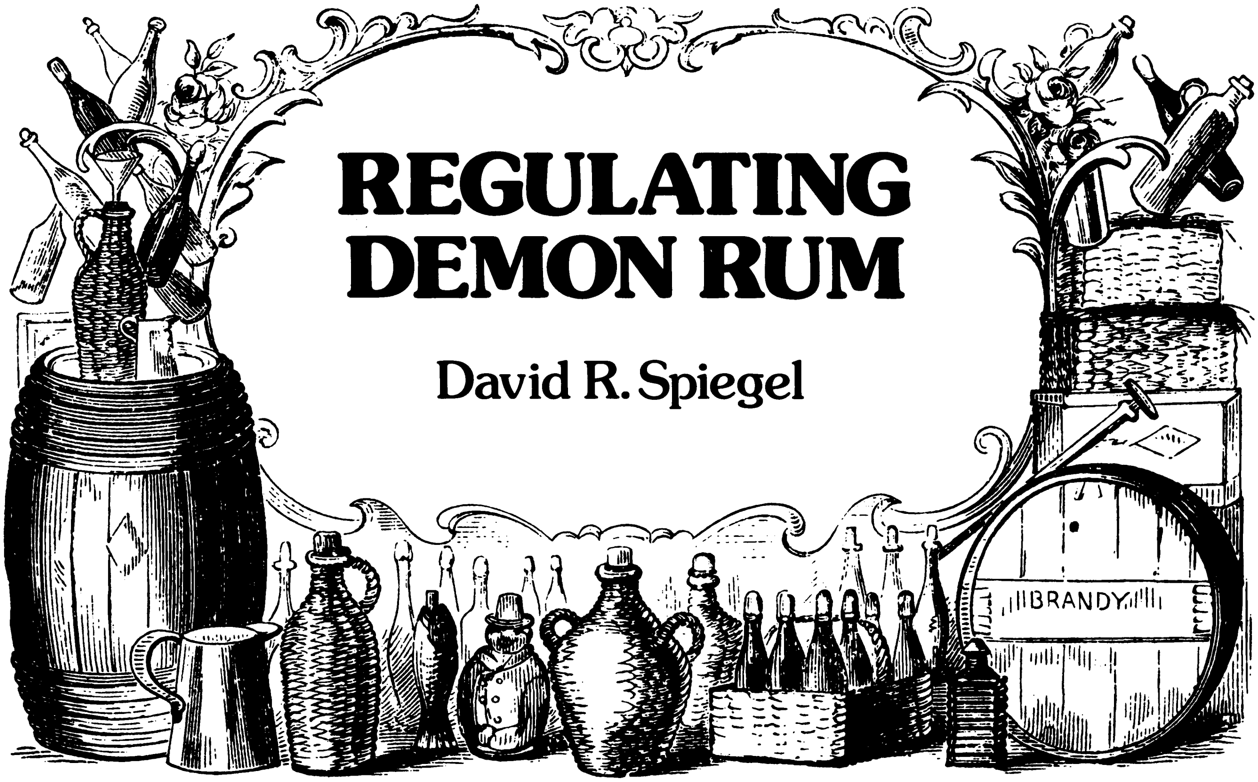

REGULATING DEMON RUM

David R. Spiegel

FOR MANY CONSUMER GOODS, the announced aim of regulation is to secure for the consumer the largest supply of goods of the highest quality at the lowest price. In the liquor business, however, these goals collide with another objective—preventing (or discouraging) excessive consumption of the product in question. As a result, many state alcoholic beverage laws wind up attempting to drive up price and curtail supply. The goal is not to prohibit the sale of liquor—the traumatic experience of prohibition cured most policy makers of that urge—but to achieve some sort of middle ground between prohibition and an unfettered market.

Under the banner of temperance, the fifty states have passed a great variety of laws regulating liquor distribution. To what extent these laws have reduced problem drinking is unclear. Their major effect, however, is often to benefit various local groups. Economist George Stigler has postulated that "as a rule, regulation is acquired by [an] industry and is designed and operated primarily for its benefit." In the liquor industry, this is especially true.

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The Constitutional Background

The Twenty-First Amendment, which ended this nation's fourteen-year experiment with Prohibition, included a clause (section 2) that guaranteed each state the right to control "transportation or importation" of alcoholic beverages destined for "delivery or use" within its borders. This clause reflected a mistrust of federal authority, which had been exercised badly, many felt, during the Prohibition era. A proposed third section to the amendment, which would have given Congress concurrent power "to regulate or prohibit the sale of intoxicating liquors to be drunk on the premises where sold," was deleted during Senate debate on the ground that it could be interpreted to justify federal supremacy over state efforts at liquor control.

Not surprisingly, given this legislative history, courts have construed the Twenty-First Amendment as giving each state virtual autonomy to structure its distribution system as it pleases and decide who, if anyone, it will license to participate in that system. "It is well established," the Supreme Court noted in *New York State Liquor Authority* v. *Bellanca* (1981), "that a state has broad power under the Twenty-First Amendment to regulate the time, places, and circumstances under which liquor may be sold." States have used this broad power to enact a variety of regulatory regimes, from total prohibition of liquor sales, which prevailed in Mississippi as recently as 1966, to the relative latitude that prevails in Nevada, where there are virtually no restrictions on advertising, store hours, or pricing. More relevant to this article is the distinction between "control" and "license" jurisdictions. In the eighteen "control" jurisdictions (as well as Montgomery County, Maryland), the government itself acts as the wholesaler and in most cases the retailer for distilled spirits. In the thirty-two "license" jurisdictions (as well as the District of Columbia), the government licenses private parties to perform the wholesaling and retailing functions.

And this is only a starting point. Within the control and license groups there are broad differences in individual laws. These are highlighted in a biennial publication, *Summary of State Laws and Regulations Relating to Distilled Spirits*, published by the Distilled Spirits Council of the United States (Discus, a Washington-based trade association and a leading source of data on the alcoholic beverage industry). For instance, three states—Mississippi, Utah, and Oklahoma—prohibit virtually all forms of advertising and other promotional devices. At the other end of the spectrum, nine states impose almost no restrictions. In between are thirty-eight jurisdictions (and the District of Columbia) that have their own idiosyncratic requirements—such as prohibitions on use of immodest or undignified women in ads, bans on any references to therapeutic effects of liquor, and prohibitions on portrayals of Santa Claus. Apart from advertising, there are also wide variations in credit laws (wholesale and retail), in price and discount restrictions, in import restrictions (from absolute bans to no restrictions at all), in what products retailers can sell other than alcoholic beverages, in restrictions on outside ownership interests, in licensing requirements, and in tax laws.

The result is a system that emphasizes knowledge of minutiae and legal trivia, with a Byzantine price structure that encourages consumers to evade local laws and shop for their favorite brand in a neighboring state. According to 1984 Discus price data, retail prices on the fifth size of certain name brands of liquor varied more than 100 percent from high to low jurisdictions. Wide fluctuations in a single region are commonplace. For example, in Kansas liquor prices averaged 79 cents a fifth higher than in neighboring states.

Social Policy

The ostensible policy goal of virtually all alcoholic beverage regulation is to promote temperance (or, in the more modern, "medical" parlance, reduce substance abuse). This goal is cited again and again in legislative debates and statutory preambles. Although other social objectives are sometimes mentioned—for example, keeping criminal elements out of the industry—they have a decidedly subsidiary role.

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There is comparatively broad agreement among industry analysts that the surest way to reduce liquor consumption is to raise the price of liquor. How big a price rise is needed to bring about any given cut in problem drinking is unclear. But one thing appears certain: keep raising prices and at some point, all else remaining constant, consumption will drop.

The obvious way to drive up the price of liquor is to tax it, and all fifty states do so. But most states go further, attempting to control or influence the price at which liquor is sold. The states with liquor monopolies use markup formulas to set a uniform shelf price for each brand. The others mostly use more indirect regulatory means toward the same end.

Formerly, many license states used "mandatory markup" laws that required retailers (or sometimes distributors) to mark up prices by a stipulated minimum percentage. However, such laws have become increasingly unpopular. They put the state in the role of a price-fixer or an accomplice to price-fixing arrangements, without actually letting it take charge of the distribution apparatus. Only three states—Wisconsin, Kansas, and New York—have retained markup formulas, and in one—New York—two separate state courts have recently found that the practice violates federal antitrust laws. These decisions are currently on appeal to the state's highest court.

In the absence of markup laws, license states attempt to influence price through a variety of indirect restrictions affecting the conditions under which liquor is sold or wholesaled, who may sell it, and which consumers may buy it. However, these restrictions (many of which are also in force in control states) have only an incidental impact on price, and create a number of unpredictable nuisance costs for consumers, as will be shown later. They also have certain not-so-incidental effects, oftentimes designed for the benefit of local business interests and having little or nothing to do with consumer welfare.

The Interest Group Factor

It is an article of faith among state liquor regulators that only vigilant law enforcement can thwart control of local liquor retailing by unwholesome out-of-state suppliers. This attitude has its roots in the pre-Prohibition view that the major devils leading innocents down the primrose path to intemperance were the distillers and brewers and the "tied houses," or retail establishments, that they dominated. The regulatory solution was not unlike that proposed for the oil companies in the 1970s: vertical divestiture. The thirty-three states with private liquor systems adopted a "three-tier" distribution system, separating the liquor industry into (1) suppliers (usually distillers or importers), (2) state-licensed "distributors" or wholesalers, and (3) retailers.

On the surface, this three-tier system looks much like the distribution system used for other common products such as groceries or soft drinks. What makes it different is the enormous restrictions all license states place on dealings between the tiers. The wholesaler, in particular, is supposed to serve as a kind of buffer separating local retailers from the machinations of the faraway suppliers. This system may have succeeded in wiping out the lobbying influence of the suppliers. Unfortunately, it has turned the local tiers—the retailers and particularly the wholesalers—into potent interest blocs of their own.

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In state lobbying battles, distributors and retailers tend to portray themselves as local underdogs besieged by wealthy outsiders. The true picture is more complicated. Retail liquor stores in most states commonly gross more than $1 million a year. About half of all American supermarkets now carry wine, and in some states (notably California) they sell liquor as well. Many of them have corporate ties outside the jurisdiction. Although "mom and pop" stores remain a major factor in some states, it is mostly because collective lobbying has kept out competition by chains. In Kansas, a state study found that the typical retailer earned just $8,194 in 1980, and that there were considerably more liquor stores per capita than in comparable states.

Distributors are even larger. Recently released census figures show that the typical wine and spirits wholesaler had mean annual sales in 1982 of more than $11 million. That is probably an underestimate, because the census figures treat as separate entities many seemingly distinct licenses and warehousing facilities that in fact operate as a system. In New Jersey, according to a 1978 report by the state attorney general, five groups of wholesalers, each group financially interlocked from within, held twenty-four licenses and accounted for more than 80 percent of the distilled spirits sold by state retailers. In New York City, six dominant wholesalers were estimated to do more than $700 million in sales collectively in 1979.

Nonetheless, local firms, particularly wholesalers, have had remarkable success in securing laws to protect their interests. Take, for instance, franchise protection—an area where regulation has become increasingly popular in recent years. According to a 1984 report prepared by the Wine Institute of America—a California-based trade association—forty-two states apply such laws to one or more alcoholic beverages, seventeen of which apply them only to distilled spirits.

The purpose of franchise protection laws is to limit the supplier's freedom to terminate or modify sales arrangements with distributors. Typically, these laws require the supplier to show "cause" if it wishes to switch distributors and the distributor objects. The administrative and judicial requirements for establishing cause effectively block all but a handful of franchise shifts. They also inhibit significant modifications of existing sales arrangements.

The effect, of course, is to insulate established distribution houses from competition by new entrants. This occurs because in most markets, either as a result of historic practice or requirements in state law, franchises are commonly awarded to one or, at most, two distributors. As a result, newcomers cannot enter the market because they cannot find the popular brands that are indispensable for successful entry. Liquor is an area with strong brand loyalty; more than half of the national liquor case sale volume in 1980 was generated by thirty-six brands.

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In a majority of license states, distributor influence is augmented by "primary source" and "at rest" laws. The former forbid out-of-state suppliers from selling to wholesalers in the state unless they are the principal American supplier of the brand in question. The latter require out-of-state suppliers to sell liquor only to licensed state distributors rather than directly to retailers. The effect of both kinds of laws is to prevent wholesalers or retailers from undercutting established distributors.

One example of the way such laws work is the recent severing of the "Oklahoma connection" that linked California retailers to Oklahoma distributors. The link arose because distributors in Oklahoma were willing to sell popular, brand-name spirits at prices below those of established distributors in California. California retailers sought to take advantage of the price differences by importing out-of-state liquor through in-state wholesale operations that were outside the established network. This strategem, however, was short-lived. After an outcry from the established distributors, the state legislature passed a law permitting a supplier to designate a local distributor for its products and then forbidding California retailers from buying the products from another source.

Another link in the system consists of state "posting" laws. These require distributors to notify state regulatory commissions of their prices for all brands, publish these prices regularly, and keep them the same during the "posting period." More than half the license states, including such high-consumption jurisdictions as New York and California, have such laws.

Posting laws can inhibit price competition in two ways. First, since a price-cutter knows that its discounts will probably be matched by competitors, with a mutual loss of income, there is a strong incentive to preserve the status quo. Second, posting provides a mechanism for direct collusion. This latter problem was the subject of a 1982 Department of Justice case against six New York State wholesalers. The case, *United States* v. *Charmer Industries*, ended when wholesalers agreed not to exchange prices and discounting information. In New Jersey, a 1978 report prepared by the criminal justice division of the state attorney general's office referred to a pattern of close, possibly collusive conduct between suppliers and distributors arising partly as a result of the state's posting laws. The relevant provision, which was subsequently changed, permitted distributors to amend prices in their filings after viewing postings of competitors.

A number of states also require suppliers to offer wholesalers in the state at least as low a price as they have charged any buyers in other states during the preceding month. This sort of "most-favored-nation" clause (called an "affirmation law" by the industry) creates pressure for a single nationwide price rather than prices which take into account consumer preferences in different regions.

This practice was upheld in a 1966 Supreme Court case. However, a more recent variant passed by Connecticut in 1981 has been found unconstitutional. That law provided that beer suppliers could not charge Connecticut distributors more than the lowest price they offered in neighboring states. (Consumers had been crossing the border to New York State to buy beer.) Unlike the usual statute, the price comparison was to apply prospectively; suppliers had to give Connecticut the best price they were *planning* to charge in an adjacent state during the next posting period. Beer suppliers challenged the law in court, and the United States Court of Appeals for the Second Circuit eventually declared that it violated the Commerce Clause.

Court Challenges

In recent years there have been a number of court challenges to state laws and regulations. Although the possibilities of change through this approach appeared promising after a 1980 Supreme Court decision involving the federal antitrust laws, subsequent cases suggest that any optimism was premature.

The 1980 case—*California Retail Liquor Dealers Association* v. *Midcal Aluminum*—invalidated a California pricing statute that required suppliers and distributors to set a joint retail price for their offerings and then file this with the state liquor commission. Such a law, the Court said, constituted price-fixing forbidden by the Sherman Antitrust Act.

The case marked the first time that the Court had used the Sherman Act to invalidate a state's regulatory prerogatives in this area. In so doing, the Justices specifically rejected California's argument that its right to pass such laws was shielded by the Twenty-First Amendment. They also turned aside a contention that the laws were a form of "state action" protected from antitrust scrutiny under a principle dating back to *Parker* v. *Brown* (1943). Both of these defenses had heretofore been viewed as almost foolproof.

Two years later, however, in *Rice* v. *Norman Williams,* the Court signaled that antitrust suits against state price regulation were likely to be kept on an extremely short leash. A California state court had struck down the state's attempt to sever the Oklahoma Connection as a violation of the Sherman Act. A unanimous Supreme Court overruled the state court, declaring that a state statute would be preempted by the Sherman Act only if the private conduct that it mandated "necessarily constitutes a violation of the antitrust law in *all* cases" (emphasis added). This requirement of *per se* illegality, as any antitrust lawyer knows, imposes a heavy burden on prospective plaintiffs because such violations are comparatively rare and can probably be avoided by artful legislative draftsmanship. Moreover, the state action defense to antitrust scrutiny was given a new boost by two decisions during the Court's present term—*Southern Motor Carriers Rate Conference* v. *United States* and *Town of Heille* v. *City of Eau Claire.* In future liquor cases, the antitrust focus will probably return to the conduct of the private parties rather than the effects of state laws on competition.

State statutes have also been invalidated when they conflicted with constitutional provisions and when a balancing test suggested that there was no significant local government interest on the other side. For example, a Massachusetts law granting churches the right to veto license applications for liquor stores or bars within 500 feet of their premises was found invalid under the Establishment Clause. In its term ending 1984 the Supreme Court invalidated a provision of a Hawaii excise tax that favored local liquor producers. The Court found that this improperly burdened interstate commerce. In the same term the Court also invalidated on First Amendment grounds an Oklahoma statute that the lower courts had construed to prohibit liquor advertising on cable television.

The more typical judicial reaction, however, is to yield to state discretion. Thus courts have upheld state-enforced mandatory markups for retail prices, exclusive dealing requirements, a ban on advertising, and, to move afield a bit, restrictions on topless and bottomless bars.

A New Perception

As I have suggested, there is a wide variety of alcoholic beverage regulations that can be addressed in piecemeal fashion through court challenges or through legislative amendment. However, this is only a first step. Effective reform of liquor control policy involves an altering of deep-rooted perceptions.

State liquor regulation is driven by suspicion of the give and take of a competitive market. To permit market supply and demand to determine price is to risk intemperance. Thus any law that might conceivably reduce supply or increase price can be rationalized as pro-consumer.

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This view is unfortunate. It overlooks the fact that many so-called pro-temperance provisions—advertising laws, promotion restrictions, limitations on what liquor stores can sell, on when they can be open—affect price only by attaching quixotic "dead-weight" costs to the purchase of liquor. Moreover, such provisions may backfire. For example, if strict closing hours are enforced, many consumers may make their liquor purchases on the way home from work instead of on an "as needed" basis —or they may stockpile liquor at home, tempting themselves to drink more. If liquor stores are forbidden to sell food, consumers might have to drive to a second store for potato chips and dip instead of making all their purchaes in one place—or they may buy the liquor but go without snack food, thus suffering the ill effects of drinking on an empty stomach. These indirect impacts are undoubtedly annoying to consumers, but it is hard to know how much effect they have on temperance.

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Furthermore, many state laws that act to raise prices are mere interest-group provisions masquerading as temperance laws. These simply transfer monies from consumers to the private interests that sought the provisions. A more efficient means of raising liquor prices would be through a direct tax. Although liquor tax policies vary widely from one state to the next and are frequently at cross-purposes with the jurisdiction's other regulatory policies, this method at least guarantees a direct revenue flow to public coffers. To encourage (or wink at) anticompetitive conduct in the name of temperance is to waste the wages of sin.

Nor is the prescription for liquor control practices by the monopoly states without significant costs. State liquor store systems have been criticized for skimpy brand selection and variety, inconvenient store locations, inflexible pricing, and general unresponsiveness to consumer demand. And government bureaucracy is a vested interest of its own, susceptible to patronage pressures and interest wielding by local politicians. Worse, it is an interest group emancipated entirely from the pressures of the competitive marketplace.

In the final analysis, perhaps the most significant lesson of the post-Prohibition era is that government regulation is inherently limited as a way to promote temperance. Fifty years after Prohibition ended, this lesson has yet to be learned. ■