DIVESTING THE PENNSYLVANIA LIQUOR CONTROL BOARD

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Mr. Chairman, members of the committee, my name is Geoffrey Segal. I am the director of government reform policy at the Reason Foundation, a public policy research and education institute based in Los Angeles. Reason first began researching privatization and public-private partnerships (PPPs) in the late 1970s and is the publisher of the worlds two longest running periodicals on privatization—the monthly *Privatization Watch* and our *Annual Privatization Report*. Our experts have advised numerous governments on how privatization and public-private partnerships can improve services and reduce costs.

I am joined by my colleague Geoff Underwood, a senior policy fellow at Reason. In partnership with the Commonwealth Foundation, we are conducting a national evaluation of alcohol policy—specifically analyzing the differences in revenue and population impacts related to state alcohol control policies. The study is in development and today's testimony is a preview into our preliminary findings and options.

Traditionally, privatization of public services or functions has been driven by efforts to reduce the costs of government services. However, when considering divesting the Pennsylvania Liquor Control Board, a different set of goals emerge.

Privatization of the LCB would likely benefit the consumers of Pennsylvania through increased choice and lower prices. Drinking age adults in neighboring states are entrusted to responsibly shop for beer, wine, and spirits in stores that are convenient, offer greater choices, and lower prices. Why shouldn't Pennsylvanians? Private stores have more freedom and flexibility to innovate and be more responsive to the customer—store hours and locations will be driven by market demand, likely offering more and tailored options than centrally owned and operated entities. The benefit of eliminating the government's monopoly of wine and spirits is that independent but regulated private sector businesses are forced to compete on price, quality, and choice.

Privatization of the LCB would also likely benefit the state's financial outlook in two ways. First, ongoing revenues will not be negatively impacted. Taxes on wine, beer, and spirits don't go away with privatization. Those revenues will continue to flow, if not go up, with increased sales. Any revenues that are collected from licensing bars and restaurants will also continue to flow into the Commonwealth's coffers. In addition, a new form of revenue will be generated through privatization—licensing of new retail stores. Given that the Commonwealth will remain the regulatory body (even with divestiture) the LCB could serve as the licensing body for new retail establishments. Further, private establishments also pay income and property taxes representing additional revenue streams to the state and local governments.

In a moment, my colleague Geoff Underwood will expand on the impacts of control states on consumers including higher prices, reduced choice, and convenience. Further, he'll discuss the impacts on the state including the cost of ownership and operation as well as revenue impacts.

But first, let me assuage some fears that privatization is somehow unproven. Since 1985 the global sale of state owned enterprises has generated more than $1 trillion.[1] Asset sales have been accepted as a sound public policy in Sweden, the new labor Great Britain, and even in

China. In the United States, the sale of utilities, parking garages, and other assets have generated more than $225 billion in revenue for state and local governments.

In 1997, Price Waterhouse conducted privatization analysis of the LCB. The report suggested the state could realize $600 million if it auctioned 750 or so 10-year retail licenses. But that amount could rise dramatically if Pennsylvania would, for example, extend the duration of the spirits store licenses—a 30-year license would be worth more than a 10-year license, obviously. The per-year value of the licenses would have certainly increased over the intervening decade, too, since liquor and especially wine sales have soared exponentially in Pennsylvania and elsewhere. Sales at the state's 643 liquor stores have increased 30% over the last five years, and soon America, not France or Italy, will be the biggest consumer of wine.

The regulation of alcohol is nothing new. The idea of a government alcohol monopoly first arose in Falun & Gothenburg, Sweden in the 1850s motivated by public order and health concerns. The '*Gothenburg System*' spread throughout the English-speaking world into the early 20th century, importantly implemented at the local government level—where drinking was taking place and interventions could occur in British municipal beer halls or dispensaries in the American South.[2]

However, since the reintroduction of alcohol sales following Prohibition, direct government involvement of alcohol at the consumption level—in both control and license states—has diminished to zero, with private licensed resellers forming the primary interaction with consuming customers. As a result of this significant structural change, the state's ability to affect the alcohol problems through its distribution system has also diminished to zero.

Now the pertinent considerations in contemplating alcohol policy are largely questions of governmental revenue, indirect effects on the population, and enforcement of existing alcohol regulations.

Pennsylvania—along with 15 other states[3]—maintains a monopoly on wholesale and retail of sale of spirits while licensing bars and restaurants to sell alcohol. This method generates a significant stream of revenues to the Commonwealth through wholesale mark-ups and excise taxes, funds governmental programs including public enforcement agencies, but leaves the state disconnected from the best opportunities to meet its public health mission and promote responsible drinking.

All other states employ a method of regulating licensed private enterprises to manage wholesale distribution and retail sales of spirits, beer and wine (see endnotes for charts of wholesale and retail states[4 and 5]). Most recently Iowa, West Virginia and Alberta, Canada converted from control states to license states and have been the subject of intense study.

The experiences of these new license states provides the Commonwealth a significant advantage in designing a successful approach to conversion but also clearly demonstrates Pennsylvania can:

1. Generate a significant capital windfall from the sale of state alcohol-related assets and/or rights to retail alcohol resale,
2. Increase overall governmental revenues,

3. Create greater consumer choice while reducing external costs borne by consumers, while simultaneously
4. Improving enforcement efforts.

Importantly—as has been the experience in Iowa, West Virginia and Alberta—this can be accomplished without adverse effects on the population of Pennsylvania.

Government Revenue and Indirect Effects on the Population

Current vs. Future Cash Flows

The primary concern to most Pennsylvania policymakers is how any alteration of alcohol policy will affect revenue flows to the state. The following are top-line observations from the Pennsylvania Liquor Control Board's financials to better understand the cash flows inherent to Pennsylvania's existing control scheme and where state revenues would be replaced—or enhanced—under a privately run system:

1. ***54%*** of the PLCB's reported 2006 revenue to the state is in the form of excise and sales taxes—which, without any tax changes, would be unaffected by a retail privatization. This represents ***a total of $849,471,331.32***.
2. The 2006 reported profit of $80 million equates to a ***profit of $124,416 per state store*** or an ***11% average profit margin*** rather than the reported 30% average profit margin.
3. However, the cost to the state of funding PLCB operations (calculated at 5% interest)—***equals $16,341,655—or $25,414 per store***. As a result, the real average profit drops below $100,000 per store and below 10% profit margin ($99,000 and 9%, respectively).
4. PLCB 2006 operating costs (totaling $326,833,110) capture ***84% of the revenues*** from the state's mandated 30% liquor tax mark-up—with the remainder being termed 'profit.' Under a private system the state would collect 100% of the mark-up.
5. Under a private system, a **5% *mark-up*** would generate the same revenue to Pennsylvania—$80 million in 2005—as the current system; along with ***$377.5 million*** in state and local tax revenue.
6. It should be noted that to fully understand the total operating costs of the PLCB an analysis of additional liabilities related to PLCB employees is necessary—including pension funding liabilities. For example, the 2004 PLCB audit reported a ***$15 million liability for workmen's compensation***. Under a private system the state would no longer be responsible for thousands of PLCB employees' pensions and other government employee liabilities.
7. Pennsylvania currently collects no corporate or real estate taxes on the more than ***643 state stores***—a significant source of revenue replacement or enhancement under a private system.
8. Recently converted states—Iowa, West Virginia and Alberta—experienced growth in the number of stores and the number of state residents employed each as high as 300%, ***increasing each state's tax base while shrinking unemployment***.
9. The re-sale or reallocation of retail store leases would provide a revenue windfall to Pennsylvania and potentially redistributing high value locations to purchasers/lessees who more highly value them—again, improving Pennsylvania's tax base.

10. A revenue-neutral private system is straight-forward to develop utilizing a make-whole assessment and distributing it across the number of licenses to be sold/auctioned. A 1991 study calculated a required investment at ***29.7% of a store's current annual sales***.[6] West Virginia's auction ***realized make-whole revenues of 38.7%*** in its auction process.

Potential Revenue Windfall

Another important consideration is the fair market value for the LCB. As noted by Mr. Segal, the 1997 study conducted by Price Waterhouse at Governor Ridge's request arrived at a potential influx of $600 million for Pennsylvania's wholesale monopoly. Updated estimates now top ***$1 billion***.

A 1991 estimate for the sale of Pennsylvania's retail structure has been estimated to exceed $405 million—based on West Virginia's auction approach[7]. Updated estimates now top ***$700 million***.

If Pennsylvania were to choose to fully privatize the wholesale and retail business of alcohol sales a one-time capital influx of more than ***$1.7 billion*** could be reasonably expected. At the same time the current annual revenue streams can be ensured.

However, as noted earlier, the fair market value of Pennsylvania's alcohol business is vitally dependent on the structure of any deregulation scheme—whether full, partial or some hybrid effort. Each choice moving away from complete privatization—and additional regulations applied to private markets—results in a decreased value to the taxpayers. Likewise, the choice of a monopoly contract, multiple contracts, and the length of licenses all affect the market value.

Lost Revenue

1. It is widely known that because of high liquor prices in Pennsylvania, many residents leave the state to purchase alcohol in neighboring jurisdictions—namely Delaware, Maryland and New Jersey. Jonathan Newman, former chairman of the Pennsylvania Liquor Control Board said:

   > "*…Among states with retail operations, Pennsylvania probably has a lower return to the general fund because it loses business to neighboring states…State liquor taxes drive prices to the point that customers living near the borders buy their booze in those states…*"[8]

2. While the PLCB sets statewide prices and standard mark-ups, private markets are much more sensitive to internal and external competition and are best able to develop pricing strategies to re-capture out-of-state purchases, resulting in a multiplying effect that increases multiple tax revenues to the Commonwealth including excise, sales, corporate and income taxes.

3. By regulation, all prices and mark-ups are set by the PLCB. As a result, there is no market specialization in PA—all prices and product mix is the same in all regions. Selection is managed by committee allowing for no niche markets—such as for premium wines—within the state. Private markets allow for dynamic approaches to meet market demand and create product specialization and differentiation.

4. Additionally, by regulation, state stores are separated—providing liquor in one store, beer and wine in others. This method adds to consumer costs—in both time and transportation costs—and likely results in the purchase of fewer products, generating less tax revenue.

5. Last, by regulation, state stores are permitted to provide only prescribed complementary products—limited primarily to liquor mixes. Likewise, this method adds to consumer costs—in both time and transportation costs—and likely results in the purchase of fewer products, generating less tax revenue.

Potential Affects on the Population of a Change in Alcohol Control Policy

Effects on the population in control states vs. license states is an area of intense scrutiny—and commonly an area of selective use of competing facts. Likewise, the study of the effects on the populations of Iowa, West Virginia and Alberta following their conversions to a licensing system has been intense and marked by competing claims of increases *and* decreases in a variety of social repercussions such as overall consumption, underage drinking, drinking and driving and alcoholism.

The important fact to note is that ***there are no dramatic differences between control states and license states***. Equally, there have been ***no dramatic shifts in consumption, underage drinking, drinking and driving and alcoholism attributable to privatization in Iowa, West Virginia and Alberta***.

As noted earlier, the Pennsylvania Liquor Control Board is responsible for alcohol enforcement and enforcement funding—but it is also responsible for deriving revenue for the state from the sale of alcohol. It is not difficult to believe the focus on enforcement could be improved by removing it from its liquor sales funding source. As one Iowa state legislator noted in considering conversion from control to license, "It strikes me as hypocritical to have Iowa all uptight about drunk drivers and also sell the stuff."[9]

De-Mythifying Privatization

This panel will hear divergent opinions and interpretations of research conducted on the Iowa, West Virginia and Alberta experiences as well as general differences between control and license states. As noted before, the structure of privatization is the more important driver than privatization itself—as it is often stated, "***the devil is in the details***."

Before discussing recommendations for Pennsylvania, I would like to directly address a number of common arguments made against privatization—especially noting specifics of the Iowa, West Virginia and Alberta approaches and experiences:

1. Deregulation results in an increase in alcohol outlets.

License states retain the right to grant—and limit—the number of retailer and wholesale licenses. If an increase in total number of outlets is not desired, Pennsylvania can easily establish a graduated process of granting new, additional licenses each year—or develop an alternative method.

2. Deregulation/Increased availability of alcohol results in increased alcohol consumption.

Implementation of Iowa, West Virginia and Alberta deregulation followed a trending period of moderate increases in per capita alcohol consumption. As a result it is difficult to attribute causation to a trend that continued after the implementation of privatization. Equally, much of the trend of increased overall consumption coincided with a general increase in wine consumption, importation and production which occurred in the late 1980s/early 1990s. Last, while Iowa, West Virginia and Alberta experienced increases in outlets—licensed by the various regulatory bodies—each outlet sold significantly less product than state-run stores. In effect, the purchase of alcoholic beverages was simply distributed over a greater number of stores.

3. Deregulation results in either increased or decreased consumer prices.

Arguments of increased prices and decreased prices are commonly made by opponents to a licensed alcohol system—with price increases demonstrating the effectiveness of the state's monopoly and a decrease in prices *ex ante* evidence that privatization increases alcohol consumption. In fact, depending on the method chosen, prices can increase, decrease, or remain the same—as detailed in the Price Waterhouse report. Importantly, as is commonly noted in local research, Pennsylvania consistently maintains the highest beer, wine and liquor prices of all neighboring states inducing consumers to leave the state to purchase alcohol.

4. Deregulation results in decreased state revenue.

Without question it is possible to design a private alcohol system that either increases, or keeps neutral, state revenues. Alberta's conversion approach was revenue-neutral and, in fact, ***found it necessary to reduce excise taxes multiple times in order to remain revenue neutral***.[10] Equally, as previously discussed, taking a dynamic view of the Commonwealth's economy reveals how state revenues increase by capturing a larger portion of the current excise tax, expanding the corporate and real estate tax base, better matching consumer demand and creating a dynamic market for liquor, beer and wine.

While each of these counter arguments are made by groups opposed to any deregulation of the Commonwealth's alcohol monopoly each has more to do with the structure of state alcohol regulation—whether control or license—than whether the system is public or private. Specifically, under any deregulation approach the state does not give up any rights to

1. Limit the number of wholesale/retail licenses provided;

2. Set the desired excise or *ad valorem* tax—or, in the case of a retained state-run wholesale market, to set product mark-up to generate a revenue-positive, neutral or negative outcome;
3. Intercede in the marketplace as necessary; and
4. Establish and enforce regulations.

Options

After analyzing the experiences of Iowa, West Virginia and Alberta it is clear that Pennsylvania could benefit from the advantages provided by private markets. There are several models that the Commonwealth could pursue. I will address each of them independently.

<u>I. Full Divestiture- Retail & Wholesale</u>

1. Conduct an auction similar to West Virginia and Alberta's to divest all retail outlets to private enterprises.
    a. Provide severance packages to affected employees based on tenure;
    b. Allow retail locations to set retail prices;
    c. Allow for chain enterprises in order to generate economies of scale; and
    d. Establish a revenue-neutral flat rate mark-up with provisions for decreasing over the divestiture period.

2. Conduct an auction similar to West Virginia and Alberta's to divest the Commonwealth's wholesale operation to one or more private enterprises.
    a. Establish a revenue-neutral flat rate mark-up with provisions for decreasing over time—as was necessary in West Virginia and Alberta.

Advantages:
- Large capital infusion to the Commonwealth;
- Expansion of the state's tax base;
- Net annual revenue increases;
- Decrease in annual state operating costs; and,
- No market uncertainty.

Disadvantages:
- Transition costs.

<u>II. Partial Divestiture—Retail Only</u>

1. Conduct an auction similar to West Virginia and Alberta's to divest all retail outlets to private enterprises.
    a. Provide severance packages to affected employees based on tenure;
    b. Allow retail locations to set retail prices;
    c. Allow for chain enterprises in order to generate economies of scale; and

   d. Establish a revenue-neutral flat rate mark-up with provisions for decreasing over the divestiture period.

2. Table Wholesale Divestiture for future consideration.

Advantages:
- Large—though lesser—capital infusion to the Commonwealth;
- Expansion of the state's tax base;
- Net annual revenue increases; and,
- Decrease in annual state operating costs.

Disadvantages:
- Little-to-no consumer price reductions without wholesale competition; and,
- Some market uncertainty related to wholesale arrangement.

III. Hybrid Approach—Stepped Retail Replacement

1. Gradually replace PLCB retail stores with private outlets.
   a. Allow for the immediate sale of liquor, wine and beer in a single retail location;
   b. Immediately cease expansion of PLCB retail stores;
   c. All new retail stores will be licenses to private enterprises;
   d. Eliminate PLCB territorial monopolies; and,
   e. When—and if—PLCB stores lose a benchmark volume of historical sales, e.g. 25-50%, close PLCB retail outlets.

2. Concurrently divest the Commonwealth of its wholesale operations through an auction similar to West Virginia or Alberta's.
   a. Establish a revenue-neutral flat rate mark-up with provisions for decreasing over time.

Advantages:
- Lower transition costs; and,
- Steady expansion of state's tax base.

Disadvantages:
- Capital infusion dissipated over time; and,
- Lower purchase prices due to market uncertainty.

IV. Public Private Partnerships

1. Allow private enterprises to bid for the retail rights to PLCB stores.
   a. Allow sale of liquor, beer and wine in single retail outlet; and,
   b. Enterprises will manage all retail responsibilities for the state.

2. Allow additional private enterprises to bid for the wholesale rights to liquor distribution in Pennsylvania (*operations already currently contracted out*) to create wholesale competition and price benefits to consumers.

Advantages:
- Expansion of the state's tax base;
- Reduction in operating costs and employee liabilities—including pension funding;
- Net annual revenue increases; and,
- No transition costs.

Disadvantages:
- No significant capital infusion to the state.

<u>V. Pilot Project</u>

1. Choose a territory within the Commonwealth to pilot any of the above recommendations for a set period.

2. Monitor revenue collection and enforcement actions.

Advantages:
- Data collection and consumer reaction prior to decision-making.

Disadvantages:
- Longer-term effort; and,
- Loss of near-term capital infusion.

<u>VI. Local Divestiture</u>

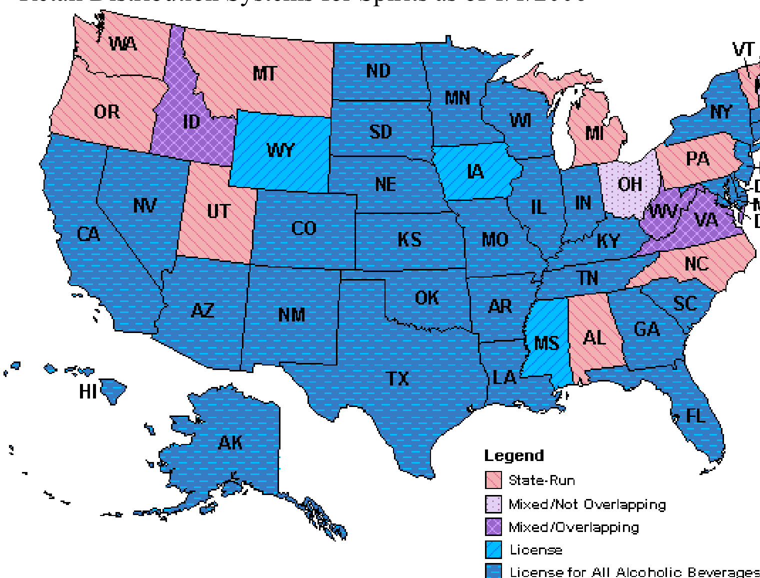
1. Allow local jurisdictions to decide alcohol sale regulations locally.

Advantages:
- Local control.

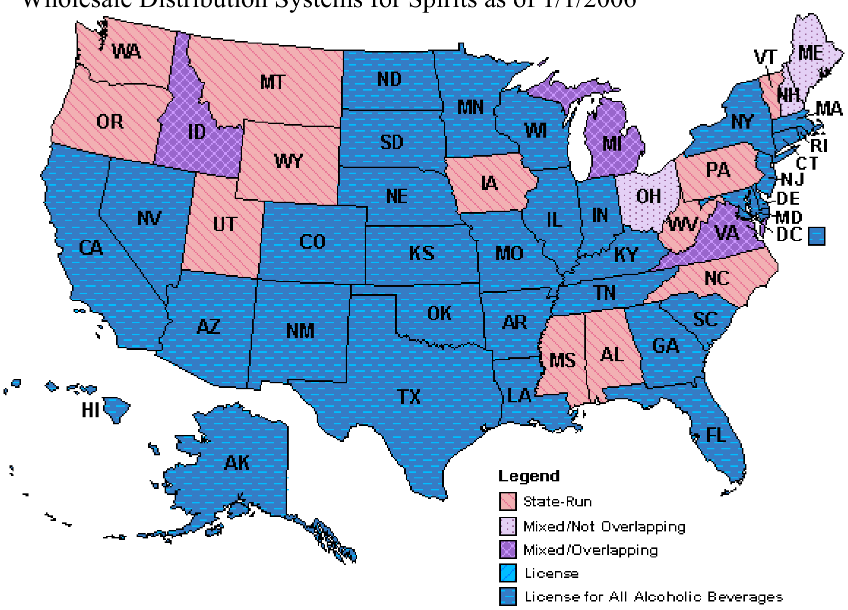
Disadvantages:
- Loss of economies of scale for wholesale efforts; and,
- Significant regional consumer confusion.

In conclusion, as the think tank that has done the most research on privatization and public-private partnerships, the Reason Foundation welcomes the opportunity to be of further assistance this committee and the Senate body as a whole. Please feel free to call upon if we can be further assistance.

[1] This figure includes the divestiture of European and former Soviet assets.
[2] "Alcohol Monopolies and Alcohol Control," Robin Room, Alcohol Research Group, Medical Research Institute of San Francisco, Revised 1991.
[3] "The American Experience with Alcohol," National Alcohol Beverage Control Association, 2006.
[4] Retail Distribution Systems for Spirits as of 1/1/2006



[5] Wholesale Distribution Systems for Spirits as of 1/1/2006



[6] "Privatization of Alcohol Beverage Distribution in Pennsylvania," Andrew Buck and Simon Hakim, Temple University, 1991, http://isc.temple.edu/economics/wkpapers/alcohol/COMMON.html
[7] Ibid.
[8] "Spirits of privatization are likely to stay bottled up," Bill Toland, Pittsburgh Post-Gazette, February 16, 2007; http://www.post-gazette.com/pg/07047/762547-28.stm
[9] Alcohol Research Group. (1991). Alcohol Monopolies and Alcohol Control. <www.bks.no/monopoly.htm>
[10] **"**Liquor Control Board: A case for the state giving up the booze business," Hans Ziegler, Evergreen Freedom Foundation, October 2002; http://www.effwa.org/inbriefs/v12_n2.php