

No Wine Shall Be Served Before Its Time— At Least Not Without Wholesalers Taking a Cut

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Despite the flagging economy and historic unemployment rates, in Washington, D.C., it's business as usual. Efforts to promote real economic growth may flounder, but the cronyism typified by the Wall Street bailout continues unabated, and it seems no special interest is too small or trivial. A bill currently moving through the U.S. House of Representatives provides a sobering tutorial on how money drives politics in the nation's capital. Introduced by Rep. William Delahunt (D-Mass.), the [Comprehensive Alcohol Regulatory Effectiveness \(CARE\) Act of 2010](#) is a clear example of economic protectionism designed to shore up the monopoly profits of beer, wine, and spirits wholesalers, much to detriment of vintners, craft brewers, small distillers, and consumers, who will face higher prices and fewer choices.

SHEEP IN WOLF'S CLOTHING

According to the [official summary](#), the Care Act:

Amends the Webb-Kenyon Act to: (1) state that it is the policy of Congress that each state or territory shall continue to have the primary authority to regulate alcoholic beverages; (2) prohibit unjustified discrimination against out-of-state producers of alcoholic beverages in favor of in-state producers; and (3) establish higher evidentiary standards for legal actions challenging the authority of states or territories to regulate alcoholic beverages.

Amends the Wilson Act to eliminate the requirement that a state or territory regulate the importation of all fermented, distilled, or other intoxicating liquors or liquids to the same extent and in the same manner as such liquors or liquids produced in such state or territory.

Taken at face value, the legislation appears innocuous; a simple clarification of existing law. However, the legislation is a direct response to the growing number of legal challenges to the monopolistic powers wielded by wholesalers and distributors in many states. The actual impact of the CARE Act would be particularly devastating to small craft brewers, independent wineries, and small distillers who are typically underrepresented by wholesalers but have made some inroads to consumers through direct shipping. For example, a medium sized winery in California, Cakebread Cellars, estimates that direct shipments make up roughly 10 percent of their business.¹

More specifically, the CARE Act, H.R. 5034, does two things. First, it seeks to strengthen state regulation of alcohol by clarifying the primacy of the state's authority. Second it proposes new evidentiary standards that would make it more difficult for anyone to challenge specific state

¹ Mike Treleven, "Napa Valley Leads U.S. in Direct Wine Sales," Napa Valley Register, July 2, 2010, available at http://napavalleyregister.com/news/local/article_b751e2b2-85a5-11df-8990-001cc4c002e0.html.

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regulations in the courts. And by amending the Wilson Act of 1890, the legislation makes clear that states have no obligation to treat out-of-state alcohol products in the same manner as those produced within the state.²

In clarifying the state's authority, the proposed legislation makes a simple but powerful change that swings the pendulum hard toward state regulation with the requirement that states may not engage in "unjustified discrimination" of out-of-state products. While sounding like a check on discriminatory activity, the legislation actually proposes a much tougher standard than current law that would allow the state far greater leeway to claim their form of discrimination is "justified."

This new authority is solidified by the new evidentiary standard included in the legislation, which raises the bar for anyone challenging a state law. Under the proposed legislation, the state would be "[accorded a strong presumption of validity.](#)" Moreover, the legal hurdle for anyone challenging a state regulation is much higher, putting the burden on the challenger to provide "clear and convincing evidence" that the law is discriminatory³. Under the CARE Act, a state would have no duty to justify its laws on alcohol sales; it is up to the individual to demonstrate that the state is wrong, and doing so requires a significant burden of proof.

IN SEARCH OF BALANCE

The Founding Fathers were acutely aware of the lure of economic protectionism and deliberately sought to prohibit states from imposing economic restrictions or regulations on one another. James

Madison sought to eliminate the "existing and injurious retaliations among the States" that economic protectionism created. A broader market, with the free flow of goods and services throughout the states, was critical to the development of the nation. To address such

problems, [the Commerce Clause](#) of the U.S. Constitution placed authority over interstate commerce exclusively at the federal level.⁴ Through history and precedent, a "[dormant commerce clause](#)" has emerged, which is interpreted as clarifying that if Congress has not regulated a particular issue in interstate commerce, then Congress meant that area not to be regulated and states should forbear from doing so as well.⁵

With respect to the sale of alcohol, however, there is a constitutional wrinkle. To repeal Prohibition, the Constitution was amended in 1933. The [21st Amendment](#) allowed states to enact laws with respect to temperance—the trade, possession, or importation of alcohol was required to comply with state laws. Since that time, the states have played the dominant role in regulating the sale of alcoholic beverages, something made emphatically clear in the 21st Amendment: "The transportation or importation into any State, Territory, or possession of the United States for delivery or use therein of intoxicating liquors, *in violation of the laws thereof*,

² The Wilson Act was originally passed as a means of allowing dry states to keep alcohol from other states off the shelves by requiring out-of-state alcohol to be the same laws as in-state alcohol. In effect, banning local alcohol products allowed a state to ban out-of-state alcohol without violating the commerce clause.

³ The CARE Act of 2010, p. 3.

⁴ The United States Constitution, Article 1, Section 8, Clause 3.

⁵ For a discussion of Dormant Commerce Clause Doctrine, see Brannon P. Denning, "The Dormant Commerce Clause Doctrine and Constitutional Structure," (February 19, 2001). Available at SSRN: <http://ssrn.com/abstract=260830> or doi:10.2139/ssrn.260830

is hereby prohibited.⁶ (Emphasis added.) However, this authority has always been tempered by the courts, which must balance the regulatory authority provided to states by the 21st Amendment with concerns over the Commerce Clause and interstate commerce.

Indeed, the courts have played a key role in the evolution of the marketplace, tackling tough questions that guide state policy on interstate shipments of wine, beer, or spirits. Perhaps most importantly, in 2005, the Supreme Court ruled in *Granholm v. Heald* that state regulations on direct shipping must treat in-state shippers the same as out-of-state shippers.⁷ The Supreme Court's action was the culmination of the growing legal challenges to state practices with respect to interstate shipments of alcohol.

The issue was becoming increasingly important as the number of wineries expanded dramatically while the number of wholesalers and distributors dropped significantly due to consolidations within the industry. In testimony in the House Judiciary Committee, Rep. Mike Thompson (D-Calif.) noted that there has been a 500 percent increase in the number of wineries over the last 30 years, while the number of distributors has decreased by 50 percent.⁸ These trends were also accompanied by the expansion of e-commerce and the internet, which made new systems of delivery a viable option.

The *Granholm* decision was followed by another important legal case in 2008, *Family Wine Makers of California v. Jenkins*, where a federal

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court clarified that a law that appeared neutral on its face yet had a discriminatory effect on out-of-state producers was unconstitutional. The courts rejected an appeal of this decision by Massachusetts in 2010.⁹ As acknowledged by the courts, direct shipment has become more important; today, 37 states plus the District of Columbia currently allow some form of direct shipments. The CARE Act threatens to overturn these legal precedents and limit the ability to file lawsuits challenging harsh and unfair state regulations.

THE THREE-TIER SYSTEM

In the wake of Prohibition's repeal, states predominantly adopted some form of the "Three-Tier System" as a means of regulating alcohol sales. Under this system, purportedly adopted to limit the influence of organized crime in the market for alcohol, producers never sell directly to retailers. There is always a three step process of producers selling to wholesalers and distributors who then sell to retailers who sell to the final customers. Vertical integration between the tiers is typically prohibited by states; however, a number of states allow small vintners and craft brewers to self-distribute as a means of competing in a marketplace where they might otherwise be ignored by distributors.

This system has defined the market for over 75 years, creating substantial benefits for those fortunate enough to be wholesalers and distributors. Over time and through changes in state laws, the three tier system created a system of government-protected monopolists who ultimately control the market by determining which producers eventually make it into the market and which products consumers see on the shelves of retailers.

⁶ The United States Constitution, 21st Amendment, Section (2).

⁷ *Granholm v. Heald*, (03-1116) 544 U.S. 460 (2005).

⁸ Rep. Mike Thompson, testimony before the House Judiciary Committee, Subcommittee on Courts and Competition, "Hearing on Legal Issues Concerning Alcohol Regulation," March 18, 2010.

⁹ *Family Winemakers of California v. Jenkins*, 592 F. 3d 2010

It is difficult for a small vineyard in California to convince a wholesaler across the continent to purchase its wine, because the wholesaler does not make much money carrying it. As a result, consumers enjoy fewer choices in the marketplace. As one trade publication for professional brewers noted, “First and foremost, these distributors are selling their primary brand and are therefore often unwilling to provide much attention to the smaller brands in their portfolio.”¹⁰

Due to franchise laws imposed in most states, it is often very difficult to terminate an agreement with the wholesaler. Franchise laws protect the wholesalers, and impose significant costs on producers seeking to terminate a contract.¹¹ Further, franchise laws in many states provide exclusive territory for wholesalers, reducing competition and allowing wholesalers to increase profits through their state-protected monopolies. Such practices are anti-competitive and harmful to consumers. As the Federal Trade Commission noted in its comments on a California law to implement more restrictive franchise laws, “if enacted, the Proposed Franchise Act is likely to lead to higher beer prices for California consumers, and may reduce the variety of beers from which California consumers can choose.”¹²

This is not to say that wholesalers provide no benefits to the economy. In fact, wholesalers are active in many sectors of the economy and have been a part of the American economy since the colonial era. Wholesalers are specialists with important information about local markets that provide producers an opportunity to get their products to retailers efficiently. Wholesalers also

allow small retailers access to products that allow them to compete with larger competitors. Their presence on the ground provides point of sales contacts to supplement any advertising or promotions by producers as well as ensuring an adequate inventory of products is available.

Yet as Nathanael H. Engle noted back in 1933, throughout the economy there always has been a tension between wholesalers and retailers: “Long the dominant factor in the distribution of merchandise, as has been pointed out, he [the wholesaler] gradually came to accept his position as a ‘divine right,’ and has been slow to adjust himself to the irresistible changes taking place around him.”¹³ With respect to alcohol, not only have wholesalers been slow to adjust, they have actively pursued legislation to protect the status quo and avoid any need for change.

MONEY AND POLITICS

With respect to alcohol, not only have wholesalers been slow to adjust, they have actively pursued legislation to protect the status quo and avoid any need for change.

As in all markets, technology and innovation have altered the underlying market for alcohol sales, expanding the market for both producers and consumers. New shipping and transportation technologies, along with new internet technologies, allow producers to reach a much larger group of potential customers. At the same time, consumers can both find new wineries or craft brewers that have been ignored by local wholesalers. In response to these trends, wholesalers have turned to government to protect their bottom line.

Wholesalers are political creatures and they defend their interests vigorously. Many states have enacted franchise laws on their behalf that guarantee a stream of monopoly profits. Purportedly, this is to keep producers from

¹⁰ Tom McCormick, “Distribution 101: A Short Course in Distribution Basics,” ProBrewer.com, available at <http://www.probrewer.com/resources/distribution/distribution101.php>

¹¹ *Ibid.*

¹² Federal Trade Commission, “Comment on Proposed Beer Franchise Act,” August 24, 2005.

¹³ Nathanael H. Engle, “Economic Phases of the Wholesale Market,” *American Economic Review*, Vol. 23, No. 2, June 1933, pp. 189-199.

switching wholesalers after the wholesaler had invested heavily in marketing the producer's products. Yet it is not intuitively obvious why this is more problematic for alcoholic beverages than for other merchandise where wholesalers and producers are left to come to terms through contractual negotiations in an open market.

Rather than a negotiation, the debate over direct shipment bears all the markings of such a political firefight. Technology is chipping away at the cozy relationship that the wholesalers and distributors have created with their regulators and they are fighting back, turning to the government to protect their profits in a changing marketplace.

Wholesalers are working feverishly to protect their highly prized state-protected franchises. The largest, Southern Wine and Spirits, generated annual revenues of more than \$8.5 billion in 2009, and the top ten wholesalers in alcohol generated revenues of more than \$25 billion and controlled 56 percent of the market.¹⁴ And alcohol wholesalers are far more profitable than the typical wholesaler, earning 66 percent to 83 percent more in profits than the typical wholesaler over a 10 year period.¹⁵

To ensure these impressive returns, wholesalers maintain a significant presence in state capitals and Washington, D.C. The National Beer Wholesalers Association, for example, ranks number 26 on the Center for Responsive Politics list of "Heavy Hitters," giving a total of \$21 million to politicians, both Democrats and Republicans, from 1989 to 2010.¹⁶ An investigation by *Wine Spectator* found that "in the five years since the Supreme Court decided *Granholm v. Heald*, both the NBWA [National Beer Wholesalers Association] and the WSWA [Wine and Spirits Wholesalers Association]

have dramatically increased spending on federal campaign initiatives."¹⁷

Of course, when discussing H.R. 5034, the legislation is swathed in noble public goals to disguise the naked economic self-interests at play. Wholesalers cling to two arguments when supporting the legislation. Specifically, they have been quick to point out the possibility of a loss of state revenue on such direct sales, as well as the potential for illegal sales to minors. Yet state regulators already have the authority to address these issues and will continue to do so with or without the CARE Act.

There is nothing unique or novel to the direct shipment of alcohol with respect to state revenues. Catalog and mail order sales have existed for some time, and are a major component of commerce. States face the same issue for orders from L.L. Bean, and there is no reason revenue from beer or wine sales should be addressed any differently. Internet tax questions are much broader than beer and wine sales, and they have been addressed as an issue of national tax policy. Direct shipping of wine comprised roughly 1 percent of total wine sales, which suggests the revenue question is trivial.¹⁸ Shipping is expensive and will naturally limit the scope of the market; the vast majority of sales will be in-state and therefore subject to revenue remittance. Wine shipments are relatively insignificant in terms of e-commerce, making it odd to propose singling them out for special tax consideration.

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¹⁴ IMPACT, April 1 and April 15, 2010.

¹⁵ Dun & Bradstreet, Industry Norms & Key Business Ratios.

¹⁶ Opensecrets.org, "Heavy Hitters: Top All-Time Donors, 1989-2010," available at <http://www.opensecrets.org/orgs/list.php?order=A>.

¹⁷ Robert Taylor and Ben O'Donnell, "Support for Direct Shipping Restrictions Builds in Congress," *Wine Spectator*, May 27, 2010, available at <http://www.winespectator.com/webfeature/show/id/42823>.

¹⁸ Mike Treleven, "Napa Valley Leads U.S. in Direct Wine Sales," Napa Valley Register, July 2, 2010, available at http://napavalleyregister.com/news/local/article_b751e2b2-85a5-11df-8990-001cc4c002e0.html.

Concern over underage sales, an issue bound to capture a regulator's attention, is also a questionable reason to oppose the direct shipment of beer and wine. While it is unlikely that underage drinkers will order expensive wines and craft beers and wait for delivery, safeguards have been established to address such concerns. A simple signature at delivery goes a long way towards eliminating abuse. States have the authority to control underage drinking without banning direct shipments. And if underage drinking were a concern, it is hard to understand why states such as Virginia allowed in-state shipping from vineyards while banning out-of-state shipments.

That wholesalers would play the public safety card is particularly ironic. For a group whose income is a function of the volume of alcohol sales to be suddenly claiming that "unregulated" direct shipments of alcohol may promote underage drinking or other irresponsible acts lacks credibility, especially considering that direct shipments comprise such a small percentage of the market. Promoting responsibility in the vast majority of the market they control may be a better use for the millions spent on lobbying by the wholesalers.

CONCLUSION

Many argue that the 21st amendment provided an exemption from the Commerce Clause, which meant states were free to regulate as they saw fit—even if that meant engaging in economic protectionism. Yet the courts made clear that the 21st Amendment does not trump the Commerce Clause. States have the authority to regulate alcohol sales, but this must be balanced against constitutional protections of interstate trade.

Laws that protect local monopolies from out-of-state competition not only harm consumers, but violate the U.S. Constitution as well. As the

Supreme Court noted in *Granholm v. Heald*: "The Twenty-first Amendment's aim was to allow States to maintain an effective and uniform system for controlling liquor by regulating its transportation, importation, and use. It did not give States the authority to pass nonuniform laws in order to discriminate against out-of-state goods, a privilege they never enjoyed. The 21st Amendment allows states to regulate issues of temperance; it does not allow them to treat out-of-state suppliers any different from in-state suppliers."¹⁹

Alcohol regulations are certainly outdated and need reforming. Unfortunately, H.R. 5034 would ensure that no meaningful reforms are even considered, leaving producers and consumers trapped in a regulatory model created in a bygone era. The CARE Act is a simple piece of economic protectionism, designed to shore up the monopoly earnings of wholesalers at the expense of everyone else. The bill already has 124 co-sponsors in the House, a tribute to the lobbying muscle displayed by the wholesalers.

Ultimately, consumers pay the price for such economic protectionism. Choice is restricted and prices are higher. The Internet provides a greater degree of economic integration that makes Prohibition-era laws on the distribution of beer and wine horribly outdated. A similar debate over clothing or CD sales would be

farcical. Yet temperance laws continue to provide opportunities to wring out more profits from the regulatory system. Arguing from pure economic greed is less appealing than framing the issue in broader concerns about temperance and the welfare of the state, but the ultimate outcome of H.R. 5034 remains the same—an extension of monopoly power to a profitable and politically well-connected special interest.

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