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Buying Wine Online

Rethinking the 21st Amendment for the 21st Century

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Archaic and unnecessary Prohibition-era laws deny Maryland consumers access to their favorite California merlots, prevent Floridians from ordering bottles of wine over the Internet, and could send Nashville restaurateurs to jail for ordering Washington wineries' products. In recent years, such restrictive laws—encouraged by politically powerful wine and liquor wholesalers who see the rise of e-commerce as a threat to their comfortable place in the market—have proliferated at the expense of consumers, producers, retailers, and market efficiency. These wholesalers' actions are emblematic of a much larger problem—"the revenge of the disintermediated"—whereby middlemen in industries ranging from autos to travel services use laws, regulations, or other restrictions to thwart more robust e-commerce competitors.[1] This report is a case study of middleman resistance in the alcohol industry, but has broader implications for e-commerce as a whole.

Distributors and retailers in most consumer goods industries face competition from new distribution channels, including big box specialty stores, large discount chains, direct shipping from manufacturer to retailer and, of course, e-commerce. But in the alcoholic beverage industry, as alternative channels emerged in the last decade, alcohol wholesalers, and in some cases retailers, have pushed for legal protections. Today, no state allows unlimited direct shipments from manufacturers to retailers or consumers. Twenty-six states require alcohol shipments to come to rest at a licensed wholesaler's warehouse while in transit from producer to retailer. Eighteen states exercise monopoly control over wholesaling within their borders. Fourteen states have "franchise laws" that legally grant wholesalers regional monopolies. Some states prohibit retailers from owning more than one store. More than 30 states prohibit citizens from purchasing beer, wine, and liquor over the Internet, with at least eight of those prohibitions being passed since 1995.

While originally intended to advance the public interest, the regulatory and legal framework now governing the alcohol industry lowers productivity, raises costs, restricts consumer choice, and limits small producers' access to markets. Even the 18 states that conduct wholesaling activity themselves restrict the ability of producers to ship directly to retailers and restrict choice in the market. There are better ways to temper the public's appetite for alcohol than by preserving outmoded vestiges of the pre-information economy.

Alcohol wholesalers argue that these legal restrictions serve key public purposes: preventing underage drinking, collecting state excise taxes, and curbing illegal trafficking. These purposes are certainly appropriate public policy goals, and it is not the aim of this paper to either encourage or discourage alcohol consumption. The specific public policy goals that wholesalers affect may also be accomplished through other, less restrictive means without causing inefficiency, decreased choice, and other market problems. Similarly, this paper does not contend that wholesalers serve no useful purpose; wholesalers exist with no legal mandate in almost every other retail industry and almost certainly would remain in the alcohol market, albeit likely with a smaller market share, if protective mandates were lifted. Therefore, it is time to bring the regulation of the alcohol industry into the 21st century by ending the legal protections for middlemen. To do this:

- Congress should clarify the respective state and federal powers controlling commerce in alcohol, namely that states cannot prohibit open competition any more than is necessary to regulate for temperance and taxation purposes.

- States should abolish mandates that legally require a wholesaling tier and other statutes that unnecessarily restrict the market, so that consumers and producers may benefit from greater choice, competition, and market access.

- The federal government should help states and industry streamline compliance procedures for the various registration and licensing requirements mandated by individual states.

The Birth of a Mandated Intermediary

In the late 19th and early 20th centuries, states and the federal government passed laws constraining the sale of alcohol. By 1890, six states had passed "dry laws" prohibiting all sale and importation of alcoholic beverages, and many others reserved that decision for local governments. To help dry states protect themselves from their "wet" neighbors, in 1890 Congress made all interstate shipments of alcohol subject to the laws of the destination state.[2] While respect for states' rights drove this decision, deeper frustration with the ills of alcohol, including the presence of "saloons" that were closely tied to producers, led to the passage of Prohibition in 1919, banning the manufacture, sale, transportation, and importation of alcoholic beverages in the United States.[3]

Widespread dissatisfaction with Prohibition led to the 1933 passage of the 21st Amendment, which repealed the ban and gave the states limited control over alcohol regulation. Likewise, to prevent the return of "tied-house" saloons, Congress passed the Federal Alcohol Administration (FAA) Act of 1935 that closely regulated the relationship between producers and retailers.[4] States almost immediately obviated this federal authority by adopting their own regulatory regimes under the auspices of the second clause of the 21st Amendment.[5] Eighteen states took the responsibility of distributing alcohol upon themselves—all of these "control states" conduct all wholesaling activity within their borders, 14 of them control retail sales of all spirits, and three control retail sales of all wine products. Other states maintained the private sector's control, but through licensing requirements ensured that wholesaling intermediaries existed between producers and retailers. The result was a market in which producers were prohibited from shipping directly to retailers and consumers, as goods had to physically pass through an intermediary's hands. This was the so-called three-tier system.

States used various policies to institute and maintain the three-tier system. Wholesalers feared that large producers would demand investment in transportation and warehousing and then abandon them before the wholesalers could recoup their costs. As a result, 16 states passed sweeping franchise laws governing the contracts between producers and wholesalers. Seven states mandate and 22 permit wholesalers to have "exclusive territories," the sole right to sell a particular product in a given region.[6] Only four states prohibit exclusive territories. As a result, along with the automobile industry, the alcohol industry is one of the few in which distributors are protected from competition by statute, as opposed to private contracts.

But these restrictions go beyond grants of exclusivity. In perhaps the antithesis of just-in-time delivery, 26 states have "at rest" laws mandating that alcohol shipments be held at the warehouse of a licensed wholesaler for up to three days before proceeding to retailers.[7] Producers must use wholesalers even when they could more cheaply ship directly to retailers. Some states require that producers disclose and guarantee to wholesalers the lowest price at which their products are sold nationwide, limiting the incentive for producers to sell at lower prices in some markets. States like Florida erect barriers to entry for new wholesalers, by requiring that they maintain a certain inventory and substantially increasing the start-up cost for new wholesalers.[8] Others like New York prohibit retailers from owning multiple stores, which limits their negotiating leverage with wholesalers and raises overall costs by precluding the efficiencies multi-store chains can bring.[9] All these provisions raise costs and lower productivity in those states. This is one reason why the consulting firm of Booz Allen Hamilton found distributors' profit margins in the alcohol industry to be more than twice those of food distributors generally.[10]

More recently, as direct Internet shipment of wine to consumers has emerged, wholesalers and retailers have pressured at least 10 states to institute direct shipping bans. For example, Florida, home of the nation's largest wine and liquor wholesaler,[11] passed a sweeping array of measures in 1997, that among other provisions, made direct shipment of alcohol to consumers a felony. In 1998, Oklahoma and Indiana passed restrictions on out-of-state shipments. In 1999, Maryland made direct shipment a felony.[12] At the urging of wholesalers, Congress passed the 21st Amendment Enforcement Act in 2000, which extended to attorneys general the ability to prosecute citizens of other states in federal court for violating state bans against alcohol importation. These laws particularly harm small producers, who wholesalers rarely represent but to whom the Internet, a richly viable alternative, is off limits.[13] And in restricting these small, boutique producers in the market, protectionist laws limit the variety of beer and wine available to consumers. Likewise, supermarkets and large discount retailers such as Wal-Mart now account for nearly 40 percent of all wine sales in the United States, yet they cannot buy directly from manufacturers even though this would in many cases be cheaper and more efficient.[14]

The decentralized nature of state liquor regulations has led to other burdensome requirements for interstate alcohol sales. For example, a producer must seek approval for its product's label from the federal government and almost every state in which it wishes to sell its product (dealing usually with the state Alcohol Beverage Control Board). Many states require shippers to register a "stock keeping unit" (SKU) number if they wish to sell even one bottle of wine. Moreover, in addition to a basic federal alcohol producer license, producers must apply for individual state licenses in the majority of states to which they ship alcohol. These and other state-specific regulations are particularly burdensome for small producers who may elect not to sell their product to a consumer when a single shipment will entail onerous paperwork and fees.

While states have passed a wide array of laws and regulations to limit competition and consumer choice, the courts have begun to look for a balance between the 21st Amendment's grant of state power and the need to remove barriers to interstate commerce instilled by the Commerce Clause of the U.S. Constitution. In several states, in-state producers are permitted to ship directly to consumers, while out-of-state producers are not. States justify this by arguing that they have more power to investigate and enforce laws over their own producers than they do over out-of-state producers.[15] However, federal courts in North Carolina, Virginia, Texas, and most recently New York have struck down such laws, ruling that the 21st Amendment does not give states the ability to favor their own wineries over those in other states.[16] While some argue that these cases may foreshadow a more general liberalization of the market, the legal precedent does not address the more widespread legal protections, particularly those mandating the wholesalers' role.[17]

The Three-Tier Mandate Is Out of Date

Defenders of the three-tier system argue that current laws serve public policy purposes, including preventing minors from obtaining alcohol, collecting state and local excise taxes, and preventing market manipulation. The reality is that these legitimate goals can be achieved without legal protections for wholesalers. For example, New Hampshire, Nevada, North Dakota, Louisiana, and Wyoming allow wine producers to sell over the Internet but require them to first register with the state and collect and remit the excise taxes.[18] Age can be verified in several ways that are just as reliable as retail clerks checking IDs.[19] Already, wine producers shipping to consumers in over 20 states must affix labels to the packages requiring that couriers confirm the recipient's identity and that they are over 21 years of age.

The last defense of distributors—that they prevent producers from manipulating the market—is simply not valid in today's economy. As laid out in the FAA Act, a goal of the three-tier system was to prevent producers from coercing retailers into unwholesome and anti-competitive business relationships. The best defense against the return of "tied-house" saloons are today's demanding customers who would simply not frequent bars and restaurants with only one brand of alcohol. But still, establishments should be allowed to cater to customers who will settle for one brand, while law enforcement can quiet any problems of saloon-era vice. With regard to monopoly power, its risk now lies at least as much on the distribution side of the industry as on the producer side.[20] Moreover, as in virtually all other industries, the Federal Trade Commission and Justice Department can provide adequate and competent oversight to enforce pro-competitive principles.

Wholesaler mandates are not only harmful in private markets; the 18 control states that conduct wholesaling activities themselves likewise restrict consumer choice, efficiency in the market, and producers' access to retailers and consumers. Such governmental alcohol wholesalers purport to temper the public's drinking by maintaining direct control over the distribution chain and to ensure tax collection. While state retail outlets may indeed assure stricter control over distribution to minors, state wholesalers cannot do the same. And as with private wholesalers, other efficient means of tax collection exist that do not undermine consumer choice, efficiency, and access to markets. State-controlled wholesaling, like mandates for its private counterpart, is unnecessary.

Finally, some worry that a free market in alcohol will flood the country with cheap liquor and exacerbate alcoholism and other problems. While end-user costs will certainly drop with efficiency gains, governments can choose to keep prices stable by raising alcohol taxes. The outcome is the same, but is achieved by letting society benefit from efficiency gains.

Modernizing Alcohol Industry Regulation

There are a number of steps that government should take to open up the alcohol industry to greater competition and consumer choice:

- **Congress should pass legislation that specifically defines the authority granted to the states by the 21st Amendment for regulating temperance and taxation. This legislation should permit states to restrict the market no more than is necessary to achieve these legitimate policy goals.** Such legislation would enable successful court challenges of most if not all state anti-direct shipment laws, at rest laws, and franchise laws because many of these laws do not aim at achieving legitimate purposes of temperance and taxation, and there are less restrictive alternatives to those that do.

- **States should repeal protectionist laws governing the alcohol industry.** Direct shipping bans, franchise laws, at-rest laws, chain-store restrictions, and burdensome regulatory provisions raise costs and limit consumer choice. In control states, mandates for exclusive control of wholesaling are unnecessary, and control states should open themselves to private competition. States can and should design regulations that meet the goals of tempering the public's drinking and ensuring tax collection, while at the same time promoting competition and consumer choice.[21]

- **The federal government should facilitate the development of interstate commerce.** To ease the burden placed on producers by 50 different state registration, approval, and licensing regimes, the federal Bureau of Alcohol, Tobacco and Firearms should coordinate a cooperative effort between states, producers, and the federal government to centralize registration,[22] licensing, and label approval[23] procedures for alcoholic beverages.

Conclusion

Whatever the rationale for the three-tier system was, it no longer applies. As in several other industries, middlemen in the alcohol industry are fighting to constrain consumers' choices and producers' access to markets in the interest of self-preservation. While they purport to fill essential public policy roles, there are clearly less restrictive means of ensuring governmental control over temperance and taxation—the market, not government regulation, should determine the role of middlemen. Be it alcohol, automobiles, contact lenses or other industries where middlemen play a strong role, there is no legitimate policy reason to deny consumers and producers competitive distribution options that boost efficiency, cut costs, and increase consumer choice.

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Endnotes

[1] Atkinson, Robert D., "The Revenge of the Disintermediated: How the Middleman is Fighting E-Commerce and Hurting Consumers." Progressive Policy Institute, Washington, D.C., January 2001. *www.ppionline.org.*

[2] The Wilson Original Packages Act was passed on August 8, 1890, and provided that all intoxicating beverages shipped interstate would be subject to the laws of the destination state upon arrival. No mechanism for federal enforcement was provided. Violators were not under federal jurisdiction until 1913, when the Webb-Kenyon Act designated the act of shipping alcohol across state lines with the intent that it be used for purposes illegal in the destination state as a violation of federal law. This Act, though rarely enforced, aimed at guaranteeing states the right to control their own citizens' use and abuse of alcohol. *http://www.druglibrary.org/schaffer/LIBRARY/studies/nc/nc2a.htm*.

[3] Manufacturers were retailing their beer and liquor at "tied houses," sellers that enjoyed deep discounts on alcohol, free equipment, and promotion in exchange for excluding competitors' products. As more producers opened outlets to compete, saloons proliferated in some places to one establishment per 150 to 200 citizens. Moreover, unfair competition, pressure from producers, and a small customer base led proprietors to turn to more insidious means of making money, and the ensuing cock-fighting, gambling, and prostitution problems provided fuel for the temperance movement. Source: *http://prohibition.history.ohio-state.edu/Brewing/Default.htm.*

[4] 27 U.S. Code Chapter 8, § 205. To this day, the Federal Alcohol Administration, now part of the Bureau of Alcohol, Tobacco and Firearms, issues licenses to the nation's producers and wholesalers.

[5] Section 2. "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, is hereby prohibited."

[6] The "good cause" needed by producers to break their contracts with wholesalers is often not met by underperformance, breach of contract, or even overt negligence of the account.

[7] These laws were passed as insurance against producers using subsidiary "paper wholesalers" to sidestep the middle tier of the system. For example, Florida passed its law in 1997.

[8] Florida Attorney General Robert Butterworth characterized the overall legislative package as legislation that allows the Florida alcoholic beverage industry "to tighten its vise grip on the distribution of alcoholic beverages…[a bill which] is the perfect tool for the vested interests who seek additional control over the marketplace, at the expense of competition and consumer choice. The legislation is anti-competitive, it is hostile to Florida consumers, and [it is] self-protective." Source: May 17, 1997 letter from A.G. Bob Butterworth to Florida Governor Lawton Chiles.

[9] For example, see New York ABC Law, Section 63, Subdiv. 5,

[10] Alix M. Freedman and John R. Emshwiller, "Vintage System: Big Liquor Wholesaler Finds Change Stalking Its Very

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Private World," *Wall Street Journal,* October 4, 1999, p. A1.
[11] Miami-based Southern Wine and Spirits, the nation's largest wholesaler, takes in $2.3 billion in revenue annually. Clint Bolick, "Wine Wars: Lift the Ban on Out-of-State Sales," *Wall Street Journal,* February 7, 2000, p.A39
[12] Maryland Alcohol and Tobacco Tax Administrative Release No. AB-21, May 6, 2002.
[13] The beer, wine, and spirits industry has changed substantially since the three-tier laws were enacted. While there were once few producers and many wholesalers, the opposite is true now, at least in wine and beer. In 1950 there were 5,000 alcohol wholesalers nationwide, today there are only 170 with the result that in some regions retailers are served by as few as two wholesalers. Conversely, the number of breweries has grown from 401 to 1,522 while the number of wineries has quadrupled. As the average size of producers has decreased and competition between wholesalers has lessened, big wholesalers find little reason to represent boutique wineries who do not sell large quantities.
[14] Mucha, Thomas, "Target Thinks Outside the Box Wine," *Business 2.0,* February 2003, p. 46-47.
[15] See remarks of William Hurd, State Solicitor of the Commonwealth of Virginia, at Federal Trade Commission public workshop on "Possible Anticompetitive Efforts to Restrict Competition on the Internet," October 8, 2002, *http://www.ftc.gov/opp/ecommerce/anticompetitive/panel/hurd.pdf*.
[16] Ben Lieberman, "Internet Wine Sales: Old Monopolies Fight Against New Bottles," Competitive Enterprise Institute, Washington, D.C., August 14, 2002.
[17] *Ibid.*
[18] In the long term, software can provide an efficient means of assessing and remitting state and local excise taxes, especially for transactions conducted over the Internet. See Atkinson, Robert D., and Randolph H. Court, "Internet Taxation: A Software Solution," Progressive Policy Institute, Washington, D.C., September 1999. *www.ppionline.org*
[19] Michigan Assistant Attorney General Irene Mead testified at the October 8, 2002 FTC Workshop on Possible Anticompetitive Efforts to Restrict Competition on the Internet that in a recent sting operation, one-third of online beverage alcohol companies sold their product to their child-investigator. She was also quoted at the same workshop as saying that the similar success rate for in-store stings is 20 percent. This 13.3 percent differential is remarkably low, considering that courier companies and their employees have no standard practices for age verification in Michigan as they do in legitimate direct shipping states, and that the confusion of many different state direct-shipping regimes has halted any industry-wide effort to legitimately address underage sales. It is certainly plausible that with a nationwide direct-shipping market and enhanced federal enforcement procedures, producers and couriers will act systematically to cut under-age sales to even less than storefront retail's 20 percent. Moreover, given that under-age drinkers living with their parents will have no way of knowing when the shipment of wine will arrive, they are taking a significant risk that their parents might be home when the package arrives.
[20] See endnote 13.
[21] For example, in 2001, New Hampshire—a control state—enabled producers to directly ship up to sixty bottles of wine and liquor and up to twenty-seven gallons of beer per year to both consumers and retailers alike. *http://webster.state.nh.us/liquor/laws_licensing/direct_ship_permit.htm*.
[22] Producers could register an SKU in one place and have it disseminated to all 50 states.
[23] State regulations on labeling are aimed at temperance and taxation purposes, such as printing the alcohol concentration and quantity. In effect, such a centralized labeling system would result in a "most-restrictive common denominator" national standard, but as the most restrictive state's standard would be constrained by the "legitimate purposes" of temperance and taxation, the central registry would not result in overly burdensome regulations.