

Alcohol Deregulation by Ballot Measure in Washington State

A Status Report on the Implementation of Measure 1183



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TABLE OF CONTENTS

Background and Purpose of the Report	Page 1
History of Washington State Three-tiered System Law Prior to Measure 1183.....	Page 2
Ballot Initiatives.....	Page 3
Impact of the Privatization Movement.....	Page 4
What was I-1183 Designed to do?.....	Page 5
How was the Measure sold and what benefits were promised?	Page 8
Did the promises materialize?.....	Page 10
The Concern about Social Impacts	Page 19
How did I-1183 change the marketplace?.....	Page 20
Conclusion.....	Page 22
Notes.....	Page 24
About the Author.....	Page 26

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"As a matter of policy, the tradeoffs aren't there for me. I just don't think it's the right thing for Washington State," Gov. Christine Gregoire, September 28, 2011^[1]

Background and Purpose of the Report

In November 2011, 60 pages of Washington alcohol law were changed via a ballot measure sponsored and financed almost entirely by the Costco Corporation. Costco supported a ballot measure proposal, financed the signature gathering process and allocated \$22 million for the campaign. The measure effectively deregulated wine and privatized the state's spirits business in a deregulated manner similar to wine. This report reviews the promises made by the measure's sponsors and whether they came to fruition.

A second purpose is to assess changes to the marketplace. One purpose of alcohol regulation is to maintain a balance of market forces (sometimes referred to as an orderly marketplace). A balanced marketplace helps curtail aggressive and predatory business practices which use marketing and deep discounts to increase consumption. Increased consumption invariably leads to public health and safety problems. Therefore, it is important to see if the marketplace has changed since the Measure's passage and how changes have impacted various business segments.

Social impacts will be briefly reviewed, but two things prevent a comprehensive assessment of such impacts at this time. Shifts in social behavior do not usually occur immediately, so time must pass before a true assessment can occur. Second, it also takes time to acquire the data necessary to determine changes in drinking patterns. There are at least two major studies that will examine social changes in future reports.

History of Washington State Three-tiered System Law Prior to Measure 1183: Costco wants to sell alcohol like tires and mayonnaise.

Over the decades preceding the passage of I-1183, various changes to Washington's three-tiered system were made, fostered by The Costco Corporation. This company, headquartered in Washington State, pioneered the idea of merging retail and wholesale functions in order to sell products at deep discounts in a large warehouse-style store. They quickly learned that their business model cannot be used for alcohol because of the three-tiered structure required by federal and state law. This structure is designed to prevent "vertical integration"; i.e. a merger of retailing, wholesaling and/or manufacturing. Such integration typically floods local markets with cheap alcohol increasing consumption and social problems. This is what happened before Prohibition in an unregulated market and is similar to what is occurring in the United Kingdom today where alcohol regulations have been significantly loosened. The United States' unique regulatory model features a strong middle tier that acts as a buffer between the manufacturer and retailer.

"We sell things like tires and mayonnaise really, really efficiently..."

Richard Galanti,
Costco CFO,
Issaquah
Sammamish
Reporter,
December 16,
2009^[2]

Costco started filing law suits in the mid-1980's. These actions garnered a few changes such as elimination of minimum price requirements and price posting, but did not involve the major changes needed for Costco's business model. In 2008, after challenging a series of regulations, they lost a major case at the US Appeals Court, 9th Circuit.^[3]

At this point, Costco turned to the legislature. Instead of enacting changes, an interim task force was formed to study the three-tiered system and recommend alterations.^[4] In 2009, after reviewing recommendations, the Legislature did make some significant changes to allow ownership between tiers. Legislators had grown tired of the perennial requests for exemption to these laws for minor ownership situations or business practices that did not seem to endanger public health. And, many were convinced that some laws were historical anomalies and "modernize" the alcohol marketplace.

Despite these changes, the three-tiered system itself was not eliminated. Its structure was retained. The three tiers continued to be separately licensed. While ownership is currently permitted between the tiers, the owners must allow independent tier operations. Statutorily, this was accomplished by prohibiting the owner or representative of one tier from exercising "undue influence" over another. The term "undue influence" is defined in statute (RCW 66.28.285 (6)) and lists a series of prohibited practices. Once again, Costco failed to get the fundamental change they were seeking.

Ballot Initiatives

Unable to get the changes needed to implement their business model through lawsuit or legislation, Costco tried an initiative petition. Washington's Initiative process was originally designed to allow grass roots citizen efforts to change laws when the legislature does not act. In recent years, it has been used by special interests that have the ability to spend millions of dollars to pay for signature gathering and mount an expensive advertising campaign. This method fit Costco's aims given the corporation's ability to finance an expensive undertaking. The first attempt was submitted for a vote in 2010. It featured both deregulation of beer and wine as well as privatization of the state's spirits business. It was an expansive measure in that it would have created a large number of new spirits outlets. Initial polls showed it passing, but as the months wore on support eroded. A large and varied coalition formed to oppose it and focused on the likely increase in outlets and impact on enforcement. The measure failed.

In 2011, Costco made a second attempt at the ballot with a substantially revised measure, 1183. This Initiative focused on deregulation of wine and privatization of spirits. Beer regulation was left alone in hopes of avoiding the opposition of and funding from the beer industry. The number of new spirit outlets was limited to large stores with 10,000 or more square feet. This responded to the concern that every convenience store and gas station could sell liquor. To address law enforcement concerns, the measure included a special fund of \$10 million per year for public safety, fines for underage sales were increased and a Responsible Vendor Program for retailers was proscribed. These were touted as "beefing up enforcement resources."

With a war chest from Costco of \$22 million, the campaign enlisted law enforcement spokespeople to highlight the increased enforcement funding. They used restaurateurs and other supporters to tout the increased convenience and elimination of the "costly" state system. Lower prices were both expected and promised by advocates. This time Costco was successful, garnering 58.74% of the vote.^[6]

1183 will return hundreds of millions of dollars back to state and local governments, much of it to public safety programs. Promotion of liquor should not be a core function of government.

It's reasonable to think that competition will bring down prices. The market and consumers will determine what the price is. Every expert says that prices will go down from current state markup.

Kathryn Stenger,
Seattle Times
Editorial Board
Debate^[5]

Impact of the Privatization Movement: Getting Government out of the Liquor Business

The Privatization movement had an important influence in this particular instance of deregulation. Over the centuries, there have been eras where government regulation was touted as necessary for economic well-being and other times where such regulation was viewed as detrimental. According to a 2011 League of Women Voters Privatization Study, “In the 1970’s, disillusioned with the Progressive Era vision, leadership in the increasingly global private sector became more active, asserting that burgeoning tax rates and government regulations of industry were inhibiting free trade.”^[6] They postulated that free markets were the solution to many problems including health care, product safety, bank failures and financial speculation.

Privatization got a boost from President Ronald Reagan when he appointed a Privatization Commission. That commission was to review the “appropriate division of responsibilities between the federal government and the private sector” and identify those functions that are “not ‘properly’ the responsibility of the federal government or that can be performed more efficiently by the private sector.”^[7] These basic ideas and even the words formed a basis for the Costco ballot measure campaign tapping into current beliefs that government is inefficient and costly and should stick to “core functions.”

However, the League of Women Voter’s study led to guidelines for when government functions should privatize and when they consider it inappropriate and they state, “The decision to privatize a public service should be made after an informed, transparent planning process and thorough analysis of the implications of privatizing service delivery.”^[7]

“The League of Women Voters of the United States believes that when governmental entities consider the transfer of governmental services, assets and/or functions to the private sector, the community impact and goals of such transfers must be identified and considered. Further, the LWV believes that transparency, accountability, and preservation of the common good must be ensured.”

Statement of Position on Privatization as announced by the National Board in June 2012. ^[7]

What was I-1183 designed to do? Deregulate and allow vertical integration for wine—privatization in a deregulated environment for spirits.

I-1183 privatized the sale of hard liquor and modified many regulations governing the sale and distribution of wine. Beer regulations were left mostly intact. These are the primary changes:

Philosophy and purpose: This Measure substantially changed the basic purpose and intent of Washington’s alcohol regulation.

First, it adopted privatization principles and commercial values of price/cost reduction, efficiency, convenience over public health and safety. In the Measure’s first sentence, the privatization philosophy was adopted for the people of Washington: “The people of the state of Washington, in enacting this initiative measure, find that the state government monopoly on liquor distribution and liquor stores in Washington and the state government regulations that arbitrarily restrict the wholesale distribution and pricing of wine are outdated, inefficient, and costly to local taxpayers, consumers, distributors, and retailers.”^[8, section 101] It is noteworthy that the language does not consider the impact on citizens other than taxpayers and consumers. The impact on children, others who pay no taxes and non-drinkers are not considered.

“...the state government regulations that arbitrarily restrict the wholesale distribution and pricing of wine are outdated, inefficient, and costly to local taxpayers, consumers, distributors, and retailers.”

Measure 1183, Section 101.^[8]

Second, it deleted former marketplace values of the three-tiered system: orderly markets and fostering moderation in consumption. Section 124 deleted the following language: “The legislature recognizes that Washington’s current three-tier system, where the functions of manufacturing, distributing, and retailing are distinct and the financial relationships and business transactions between entities in these tiers are regulated, is a valuable system for the distribution of beer and wine.” It also deleted language relating to “the goals of orderly marketing of alcohol in the state, encouraging moderation in consumption of alcohol by the citizens of the state.” However, goals of pursuing public safety to prevent underage drinking and “other abusive consumption” were retained as well as “promoting efficient tax collection”.^[8, section 124]

Why would Costco make these changes? First, it makes commercial values paramount, i.e. efficiency, price cutting, increased availability. Second, it sets the intent to change from a marketplace which is designed for a balance of large and small retailers to a marketplace that treats alcohol like any other commodity; and, where business practices such as extreme price reductions, volume discounting, and aggressive sales are championed. These are the practices which created alcohol problems before Prohibition and currently occur in the United Kingdom. These changes elicited little comment or notice, but could be pivotal in future law suits.

Replace the state liquor business with a private license system: The measure directed the state to replace the state-owned control system with a private license system by June 1, 2012, slightly more than 6 months after the election. State staff had to dispose of all assets, lay off employees, create a new license system for retailers and wholesalers, auction off the rights to former state store locations and change rules to conform to law changes. The fact that the state Liquor Board staff pulled it off is a tribute to their competency and dedication. Such a quick turn-around would be rare even in the private sector.

Limit new spirits licenses to large retailers: The measure limited the license privilege to retail establishments at least 10,000 square feet. This meant the large supermarket chains-- Safeway, Kroger, Costco, and Wal-Mart-- got most of the licenses and were able to immediately dominate the market. Exceptions were made for former state-owned and state-contract stores as well as for small communities that did not have a big store. These were sold to private operators at auction.

Institute new revenue measures: To ensure that the state did not lose revenue from the Measure, current sales and excise taxes were retained and new “fees” were added. The new “fees” consisted of a 10% fee on gross revenue from wholesalers for two years (and 5% thereafter) and 17% of gross retail sales. In addition, a special provision mandated that by March 31, 2013, holders of spirits distributor licenses must have paid \$150 million in fees with any shortfall assessed against the licensees based on market share. In fact, the shortfall was quite large. According to the Washington Department of Revenue, it amounted to \$104,709,405 during the period March 1, 2012 to February 28, 2013.^[9] The shortfall assessment was allocated among all distributors based on percent of sales. The largest distributor had 56.8% of sales and paid \$59,520,079. The second largest had 36% of sales and was assessed \$37,704,905. Retailers who acted as wholesalers, such as Costco, did not have to share in the shortfall assessment. Revenue was also anticipated from the sale of assets, the one-time collection of funds from wholesalers noted above, new license fees and the auction of rights for former liquor store locations. These measures greatly increased the amount of revenue for the first year, but will not continue and, in fact, the wholesale fee will decrease from 10% to 5%.

Shift advantages to the retailer by allow mixing of wholesale and retail functions and assessing fees: While the measure required that wholesalers be separately licensed, it allowed retailers to perform wholesale functions as part of their retail license without incurring the wholesale fee of 10% or having to pay part of the \$150 million shortfall. Retailers were permitted to have a central warehouse, move product from one store to another and sell to other retailers. While there was a 24 liter limit per retailer resale, no time period was listed for the limitation. The Liquor Board defined it as 24 liters per day. But, pursuant to a lawsuit filed by Costco and others, a court ruled otherwise.^[10] Thus, a retailer could sell unlimited quantities in a day as long as it was done as several single sales amounting to 24 liters or less. The shift in advantages gave retailers the ability to capture part of the wholesale market.

Instituted Deregulation Measures for Wine and Spirits: The Measure permitted volume discounts, allowed retailers to act as wholesalers and allowed direct business arrangements between retailers and suppliers. These are the specific measures needed for Costco to implement their business model for wine and spirits. To provide greater freedom to use competitive pricing, the drafters of I-1183 added four exceptions to the state's statute prohibiting a wholesaler from discrimination on price. Two of the exceptions allow price differentials based on cost efficiencies and expenses of serving a particular account. Two other exceptions are both vague and broad allowing price differentials based on "competitive conditions" and situations which amount to a "bona fide business practice" for other commodities. The Liquor Board is currently in rule-making regarding those exceptions. Since some I-1183 sponsors believe the Measure eliminates controls over price, this issue is likely to be disputed for some time.

Eliminated Controls over Advertising and some Marketing Practices: Just months before the ballot measure passed, the Washington Liquor control Board had revamped its advertising rules after an extensive process involving stakeholders. Most of that work was nullified by I-1183.

Provide revenue for law enforcement and allow input for local governments: The measure included two provisions for local governments. One required input for new liquor licenses (except that current retail licensees with beer/wine licenses were automatically eligible for spirits licenses). A second provision was designed to "maintain the current distribution of liquor revenues to local governments and dedicate a portion of the new revenues raised from liquor license fees to increase funding for local public safety programs, including police, fire, and emergency services in communities throughout the state."

How was the Measure sold and what benefits were promised?

1. **Get the state out of the liquor business.** This was a powerful philosophical argument that tapped into public attitudes about public service at the time. This was a major theme with print media. For example, the Spokane Spokesman-Review said, "Getting the State Liquor Control Board out of the business of selling booze and making enforcement its sole responsibility is perhaps the best attribute of I-1183. Coupled with the increase in money for local law enforcement, there should be more, not less, resources to stop alcohol abuse. Vote yes on I-1183."^[13]
2. **Lower prices were expected and promised in the ad campaign.** Lower prices were both implied and specifically promised. Advocates tapped into privatization beliefs that government operations are always costly and inefficient. In an ad for the Measure, the head of the Washington Restaurant Association asserted that I-1183 would reduce costs for taxpayers, consumers, and restaurants. He said it would get "rid of the costly state liquor store system."^[14] Many advocates assumed that free market forces alone would lower prices.
3. **Greater convenience.** The measure promised greater convenience by allowing large grocery stores to sell the product just like any other commodity including extended hours and days of sale. State and contract liquor stores would be sold to private individuals to continue that avenue of convenience. **The Herald Everett** said, "What will happen is consumers will have greater choice, the Liquor Control Board can focus solely on licensing and enforcement, and strapped local governments will have a new revenue source -- some of which the initiative dedicates to public safety. All compelling reasons to vote yes on I-1183."^{[14][15]}
4. **A "free market" with greater competition:** Many supporters of the measure strongly believed that it would increase competition which, in turn, would lead to lower prices. In a news article, a supporter stated, "Allowing competition in the distribution and sale of liquor creates a more efficient marketplace. This means greater efficiency, better product availability and wider selections at competitive prices for both restaurants and consumers."^[16]

Promises for 1183

"1183 is finally a good plan to get our government out of the liquor business while protecting public safety and providing more funds to vital public services."

Ken Elkenberry,
Former Attorney
General ^[11]

"We have long advocated that the state get out of the liquor business...it keeps revenue for governments while offering the prospect of competition driving down prices for consumers."

The Yakima-Herald
Republic endorsement
of Washington Measure
1183^[12]

5. **Greater revenue without new taxes:** The measure promised greater revenue without levying any new taxes. Revenue was generated by keeping the current sales and excise taxes and adding new “fees.” One-time revenue from sale of assets and auction of former state stores was also expected.

6. **Enhanced public safety through increased funding, greater focus, and strengthened laws.** In an ad for the Measure, a former attorney general stated that I-1183 was a good plan to get the state out of the liquor business while protecting public safety and providing more money for public safety.^[11] Additional money for law enforcement was promised along with greater requirements for retailers and higher penalties for violations. Local governments were promised a say in new liquor licenses.

Did the promises materialize?

1. The state did get out of the liquor business but performance of state staff suggests the claim of government inefficiency was never justified.

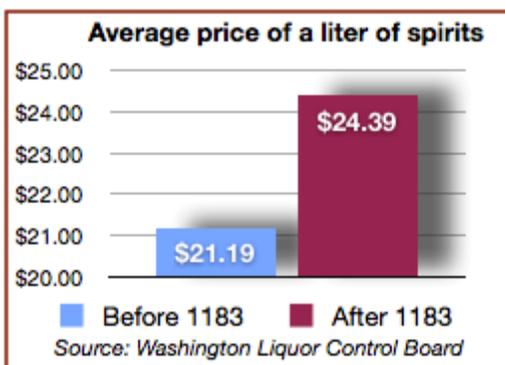
In less than a year from the vote, Washington State was completely privatized within the aggressive timelines specified in the ballot measure. One of the remarkable things about this measure is the response of the Washington State Liquor Control Board. Despite having to lay off 1,000 of their employees, they marshaled their resources, formed a series of staff teams and completed the hundreds of tasks necessary to accomplish the complicated directives of the measure. Surely, this remarkable performance belies the notion that public servants are lazy and inefficient. In a period of 7 months, the agency created several new licenses, wrote new rules, closed down and transitioned their warehouse and stores, auctioned off stores, sold equipment and inventory, laid off employees, and responded to over 10 lawsuits.^[17]

“Surely, this remarkable performance belies the notion that public servants are lazy and inefficient. In a period of 7 months, the agency created several new licenses, wrote new rules, closed down and transitioned their warehouse and stores, auctioned off stores, sold equipment and inventory, laid off employees, and responded to over 10 lawsuits.”

Pamela Erickson,
Public Action Management

2. Higher, not lower prices resulted from privatization.

Immediately after implementation, Washington’s average liquor prices shot up an average of \$2.65 per liter or a 12% increase.^[18] Since that time, prices have not changed much. In a recent article, the Seattle Times compared the average price over two years: June-April 2012 (\$21.19) versus June –April 2014 (\$24.39) and found a difference of \$3.20. Prices were so high that they have induced cross-border sales in



Oregon and Idaho. Idaho recently reported \$10 million in cross border sales. The Seattle Times also noted that Oregon’s border states experienced a 30% increase in sales. The Times also found a variety of prices in comparison to the price before privatization. For example, a 1.75 ml bottle of Grey Goose vodka was \$64.95 at a state monopoly store, \$53.58 at Costco, \$62.01 at Bevmo and \$74.99 at a downtown Seattle liquor store.^[19]

Immediate Impact: \$2.65 increase on average^[18]

The high prices are due to the fact that 1183 retained all previous taxes and added two new “fees”. Of course, adding to these taxes and fees, the distributor and retailer add their mark-ups. It should also be noted that distributors have likely added something to their prices to pay for the \$105 million they were required to pay on a one-time basis. If distributors are amortizing that

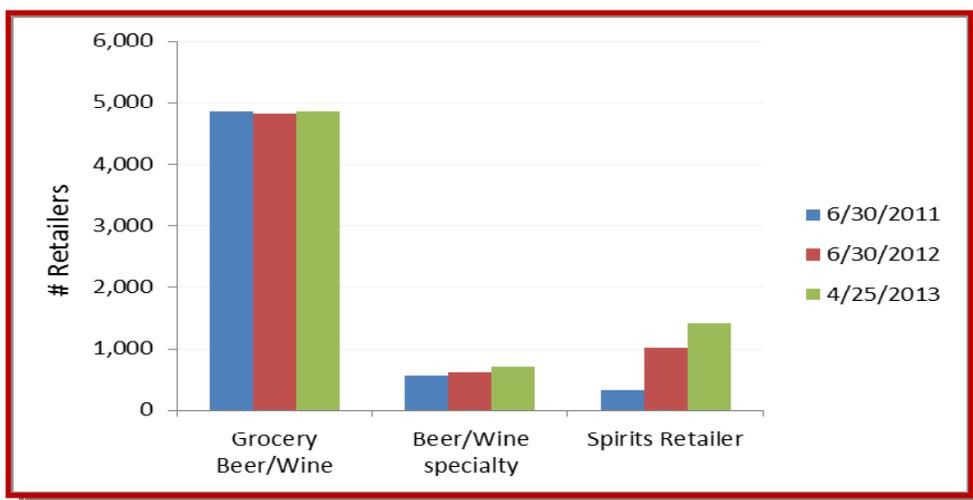
payment over several years, prices may not decline even though the distributor fee is reduced from 10% to 5%.

The prices are not just high. They are the highest in the nation by a wide margin. The difference is the tax rate. According to the Tax Foundation, Washington's spirit taxes per gallon average \$35.22. Oregon is second with an average of \$22.73. Most states have lower taxes including California at \$3.30.^[20]

3. **Consumers got more outlets for spirits, but less variety.** Convenience is a mixed bag. While consumers did get more locations with extended hours of sale to buy spirits, the products available in most of those locations are curtailed.



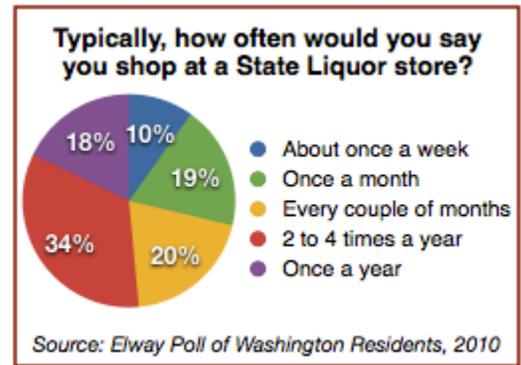
a. **Increase in availability:** Outlets increased substantially. Before Measure 1183, there were 328 state and contract stores open a maximum of 73 hours per week. After the Measure, there were 1,415 stores open a maximum of 140 hours per week.^[18] However, availability will likely decrease from the peak as more small liquor stores close. The measure required the state to auction off former state liquor stores. There were 167 such stores purchased. In March 2014, the Liquor Board noted that 116 still had licenses which means about 30% have closed. In the Seattle Times report, they mapped store closures and noted that almost 1/3 have closed. Closures were most common in the Seattle-King county area where only 34 of 61 stores are still open as of April 2014. The Washington Liquor Store Association estimates that 60 percent of these former state stores have closed in the past two years.^[21] These small stores are simply unable to compete with large grocery chains.



Change in alcohol outlets ^[18]

- b. **Product selection:** State liquor stores carried a large variety of distilled spirits products in addition to wine. According to the Washington State Liquor Control Board's website, just prior to implementation of I-1183, there were 418 brands listed with their stores. Many of these brands, such as Seagram's Vodka, have a long line of products with many flavors and bottle sizes. While every store did not carry all products, the selection was substantial. Although data is not available to assess statewide product selection after I-1183, observation of grocery and liquor stores suggests a very different configuration. Most grocery stores have a small selection and some have just a few shelves. Former state stores visited by the author of this report appeared to have a thin inventory. Since they do not have the economic clout to command large volume discounts from suppliers, they have difficulty competing. And they are now facing another competitive threat. Large liquor retail chains such as BevMo and Total Wines and More have come into the state and they do have a very large selection of products. As of April 2014, BevMo had 10 stores most of which are in the Seattle area and Total Wine had 9. Two are in Spokane, 1 in Vancouver and the rest in the Seattle-Olympia area. As a result, customers living close to a large chain liquor store have both convenience and substantial variety. Others have convenience, but a limited choice of product.^[22]
- c. **How important is convenience?** Advocates of deregulation would lead you to believe that shopping convenience is a top issue for consumers and that "one-stop shopping" is what they seek. However, consumer research shows a different pattern which is that people shop at several different types of stores per month.^[23] They buy different items from traditional grocers, club outlets, discount stores and fresh markets. "One-stop shopping" is not what is happening. Also, where one or two big box chains dominate a local market, a consumer either buys from the limited brands and sizes offered by the chains or travels some distance to a specialty store. This seems to be what is evolving in the Washington spirits market. While the number of outlets greatly increased, the availability of a large variety of products shrunk. The big chains negotiate volume discounts with major suppliers on a certain number of products where they make money. They have little incentive to carry other products. The small liquor stores which are being squeezed by the large chains can't afford the investment in a large inventory. A consumer interested in something other than the bestselling products must go to a specialty store provided one is located in their area. Some are even going to neighboring states where the selection is larger and prices are cheaper.
- d. **Finally, spirits is a niche product.** According to a survey conducted about a year before privatization, only 46% of the Washington public reported being in a liquor store in **the past year**. Of those 46%, only 10% shopped weekly (less than 5% of the population) and 19% monthly. Most shopped far less often.^[24] In the United States, 39% are non-drinkers according to a 2013 Gallup poll. Of the 60% who do drink, only 23% identified spirits as their usual type of alcoholic drink.^[25] That means that less than 15% of the public would benefit from spirit products being more convenient. While the polling data did not have state level information, The Brewers Almanac charts liquor consumption by state. Washington's rate of

1.50 gallons per capita for 2011 was almost identical to the national average of 1.54 gallons.^[26] These data simply indicate that convenience in purchasing spirits is only relevant to a small sector of Washington's population.



Elway Poll of Washington residents, December 2010. Frequency of shopping for the 46% who had visited a state liquor store in the past year.^[24]

- 4. Competition increased greatly at retail, not so much at wholesale. Competition did not bring lower prices.** Anyone who read and understood the ballot measure's 60 pages of complex provisions knew that it was not a "free market" measure. Rather it specifically gave market advantages to large, chain retailers. Except for the former state stores, only those with 10,000 square feet could sell spirits. Those retailers also could sell to other retailers without paying the distributor fee. They could buy directly from a supplier and negotiate large, volume discounts. The small stores just don't have the economic power to compete in that environment. So the retail marketplace is evolving to one dominated by large national grocery and big box liquor store chains. The wholesale level immediately became a "duopoly" with two large national spirits wholesalers taking 93% of the market share. Because the wholesalers had to pay for a \$105 million shortfall in fees on a one-time basis, it is likely that they marked-up products at a greater level. Prices may fall in subsequent years particularly since the wholesale tax (or "fee") will drop from 10% to 5%.
- 5. Greater revenue in the short term, not so likely in the long run.** Two major questions need to be answered in order to determine if the public truly benefitted financially from the ballot measure: Will the annual revenue stream be the same or more than before? Did the state receive adequate compensation from the sale of its business?

The first question is very complex because there are so many different streams of revenue. First there are two taxes levied on retail sales that were simply retained by 1183 (spirits sales and liter taxes). Two new large taxes, called "fees", were created to replace the revenue the state got from the business profits or mark-up. The establishment of these "fees" gave lie to the promise of greater revenue with no new taxes. Calling these revenue measures "fees" was simply a subterfuge. Whoever buys spirit products will pay these new "fees". A 10% fee was levied on all wholesale sales and paid by the distributor and a 17% fee on retail sales that is paid by the retailer. The illustration shows what taxes went into the price of liquor before privatization. There was no change to the state or federal taxes. The markup was replaced by the new "fees"

and the distillery price varied depending on what the retailer or wholesaler could negotiate. Finally, revenue was generated by the sale of the business assets including auction of the state stores, sale of the warehouse and all equipment.



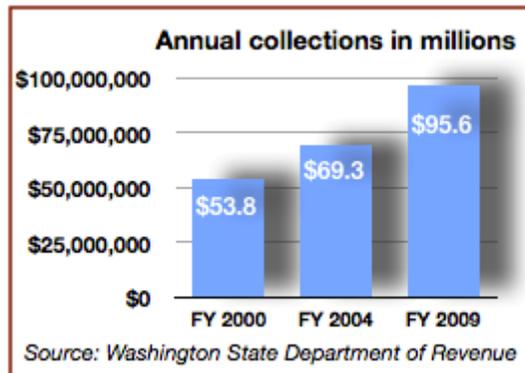
Washington State Liquor Control Board website

To date here is a review of revenue generated:

- a. **Spirit sales and liter taxes continue the historical upward trajectory but volatility has increased.** Spirit tax revenue has been increasing for some time. For example, revenue almost doubled from 2000 (\$53,756,000) to 2009 (\$96,592,000).^[27] Since privatization, revenue has increased at a higher trajectory, but with higher volatility meaning more high and low points.^[28] Additional time is needed before one can conclude whether there has been an increased rate of revenue return or just an immediate reaction to the change. 14
- b. **License “fee” revenue pumped by up by one-time assessment and will decrease thereafter:** For the first year of activity (March 1, 2012-February 28, 2013), there was a special assessment on distributor licensees. I-1183 specified that if distributor fees in that period did not equate to \$150 million, each distributor would be assessed a pro rata share to make up the shortfall. For that period only \$45,290,405 was collected which meant approximately \$104,710,000 had to be paid by all distributors on March 31, 2013. Since two distributors had over 90% of the market share, they each wrote some large checks. One paid

\$59,520,079 and a second paid \$37,704,905! Without this provision in subsequent years, there will be a substantial revenue drop. [9] In 2012, license fees generated \$33.91 million;

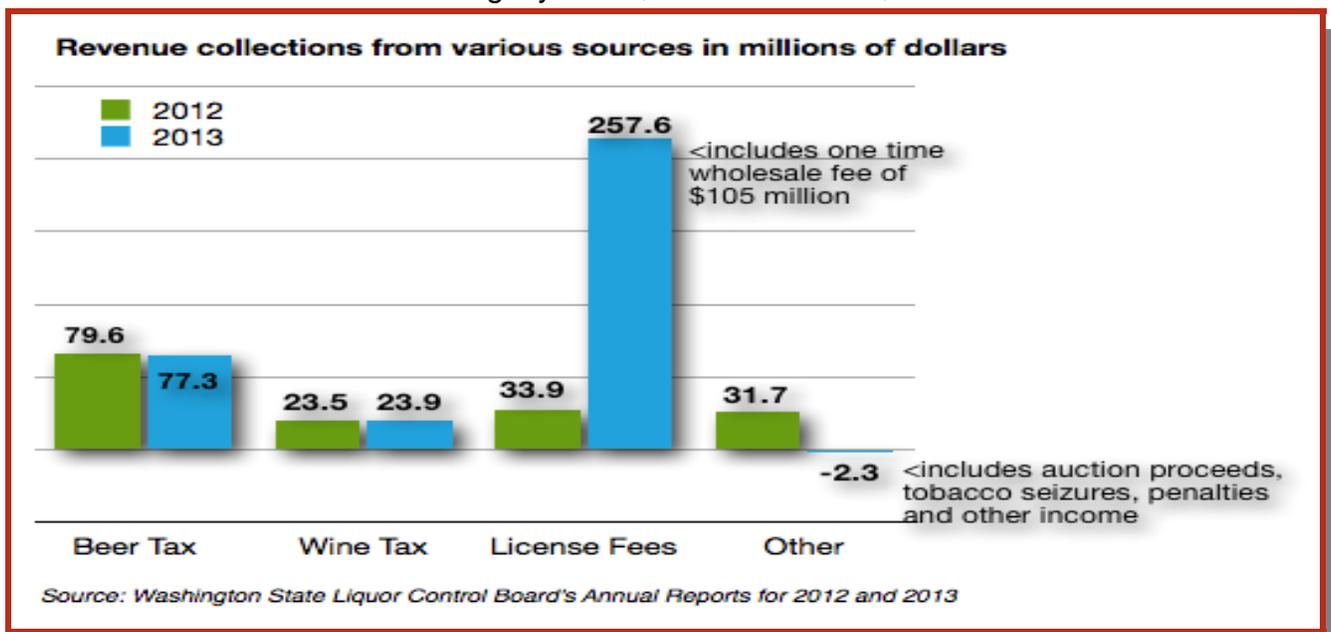
Spirits Sales and Liter Tax Collections (\$000)



Washington State Department of Revenue [27]

the next year that figure was \$257.60 thanks to the special assessment. (the license fee category includes fees for all licenses issued by the WSLCB). This level of revenue will decrease just as dramatically. First, the one-time assessment will not be repeated. Second, in 2014 the 10% wholesale “fee” will drop from 10% to 5%. In addition, the legislature has already modified some of the fees to help the independent liquor stores which are struggling to survive.

- c. Sale proceeds: For Fiscal Year 2012, the WSLCB reported \$31.75 million in “other revenue” which includes auction proceeds, tobacco seizures, penalties and other income. Most of this total is from sale of the former state liquor stores. The next year, that category resulted in a minus \$2.27 million.^[29]
- d. Beer and wine tax revenue: It is unclear whether 1183 impacted the sale of beer and wine as drinkers exhibit a high degree of stability in terms of the primary type of alcohol they prefer. However, beer tax revenue decreased from \$79.64 million in FY 2012 to \$77.33 in FY 2013. Wine tax revenue increased slightly from \$23.45 million to \$23.92 million.^[29]



6. Law Enforcement/ Public safety:

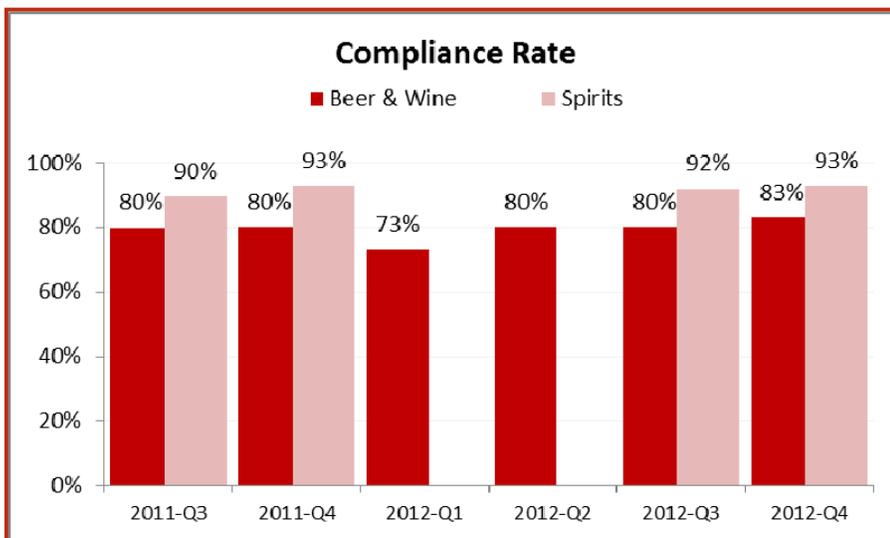
a. Additional \$10 million for enforcement didn't materialize: The measure was supposed to generate an extra \$10 million which would be dedicated to increased "funding for local public safety programs, including police, fire and emergency services in communities throughout the state." However, the state legislature has control over funds which go to local governments. According to the Washington Association of Cities, "On the last day of the 2012 legislative session, legislators approved ESHB 2823, which redirected local government liquor taxes to the state general fund for one year. When they resume, the state will take \$10 million of the local government share—essentially negating the \$10 million for public safety that the initiative provided." [30] The measure was also supposed to make enforcement more efficient by focusing the Liquor Board's mission on enforcement versus sale of spirits. The Board did get a major increase in hard liquor outlets with no new resources for that purpose. They did get a new major function with the passage of the recreational marijuana ballot measure, including additional resources, but it certainly limits their ability to focus on alcohol issues.

b. Stronger measures for public safety: The measure was to make "the standard fines and license suspension penalties for selling liquor to minors twice as strong as the existing fines and penalties for selling beer or wine to minors." An increase in penalties will not automatically improve public safety unless there is an increase in enforcement...which of course takes additional resources. Making training requirements for employees more stringent is not a bad thing, but again needs to have good enforcement to make it actually work.

"On the last day of the 2012 legislative session, legislators approved ESHB 2823, which redirected local government liquor taxes to the state general fund for one year. When they resume, the state will take \$10 million of the local government share—essentially negating the \$10 million for public safety that the initiative provided."

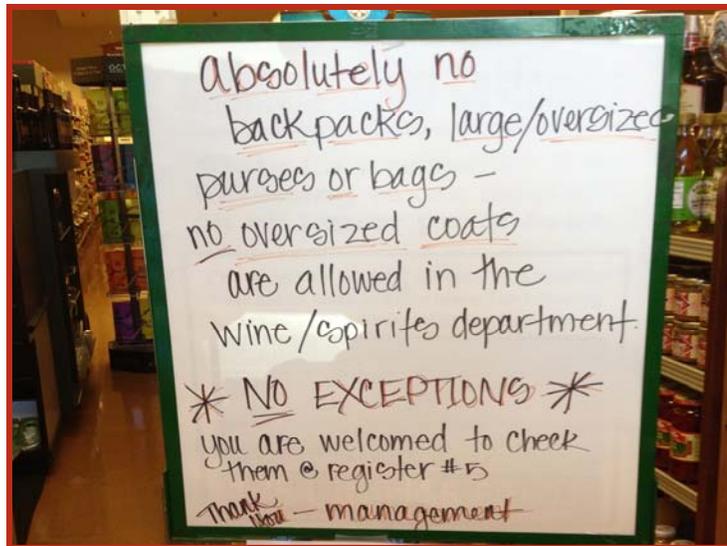
Liquor revenue, February 2013", Association of Washington Cities^[30]

c. Sales Compliance Rates: Despite the lack of additional resources, compliance rates on sales to minors remain very high.^[17] Generally, compliance rates remain high as long as regular checks are made and retailers are aware that they may be subject to such checks at any time.



Washington State Liquor Board data used in study by Julia Dilley and Linda Becker^[18]

d. Theft: One of the immediate impacts of implementation was theft of spirits products. Because prices were so high, it became a very attractive product for kids and for organized theft rings. According to Mitch Barker, Executive Director of the Washington Association of Chiefs and Sheriffs, theft is a major problem.^[31] He noted that some stores have poor security which facilitates theft by youth and organized theft rings. It is also possible that retailers are selling part of the product in their store and part directly to on-premise licensees. The small retailer can claim part of the product lost to theft which means the 17% tax is never paid. This allows a reduced price to a restaurant in an illegal sale. Barker also said there is a major lack of data on thefts because some stores report thefts and others don't. This is why the Association proposed that the Liquor Board require theft reporting.^[31]



Anti-theft measure in a grocery store

Some large chains were remarkably uncooperative either saying they don't account for losses or that such information is proprietary. Several observers, including State Representative Chris Hurst (D-Enumclaw), checked security measures at various stores and found them wanting. In a news article, he stated, "What really got me was around Thanksgiving and Christmas time, there were stores with Jack Daniels and Jagermeister that were eight steps from the door at 2 and 3 in the morning. You had to ring a bell to get someone out of the back from stocking. You could have loaded a truckload before anyone noticed."^[32] Ultimately, a bill sponsored by Hurst passed that allows the state Liquor Board to pull a license if the premise experiences an unacceptable rate of spirits theft (2 or more incidents in a 6 month period) and an underage drinker ends up with the product. While stores have been working to address the problem, a Vancouver police officer noted that "The theft is pretty constant; liquor specifically, it's targeted by juveniles and organized retail theft crews. They come in and work the I-5 corridor between here, Vancouver and Seattle."^[32]

e. Problem products: Before privatization, the Liquor Board was able to keep dangerous products out of the marketplace. Such products included pouches that are attractive to youth and easily concealed and super strength products of 190 proof which was kept off the shelf, but available with a special permit. These products now may all be sold in grocery stores.

f. Underage drinking: Like most of the nation, Washington has seen a steady decline in underage drinking. According to the Washington State Healthy Youth Survey, “Alcohol use peaked in 1998 and is currently at the lowest levels since the survey began in 1990.” However, we will not be able to assess the impact of I-1183 until more time has passed and data is available. The most recent survey was conducted in the fall of 2012 just a few months after implementation of the Measure. The next youth survey will be done in 2014.

g. Drunk driving: Like underage drinking, the US has experienced a decline in drunk driving fatalities. Many factors have contributed including passage of age 21 by all states, tough penalties and ignition interlock requirements. Until recently, Washington ranked poorly by MADD for its drunk driving record. However, 2012 was a year when a decline in fatalities occurred. MADD credits that to the ignition interlock law passed in 2009: “In 2009, an all offender interlock law went into effect. Each session since, the Legislature made improvements to their comprehensive interlock law.” Time will tell whether 1183 will impact drunk driving rates.^[33]

h. Other public safety concerns: Despite the lack of up-to-date data to measure social impacts, there are some disturbing pieces of information. In their report to the Washington Liquor Board, researchers Julia Dilley and Linda Becker reported increases pro-alcohol attitudes among youth, significant increases in older youth’ perceived access to alcohol, and increases in frequency of drinking for older boys. They noted significant increases in Emergency Department visits for alcohol-related conditions post-privatization. In King County, this amounted to 5,500 excess visits in the 16 months following privatization. Finally, a single high school survey of 1,000 students revealed that one in 10 students who drink reported stealing alcohol from a store in the past year.^[18]

The Concern about Social Impacts: Why Adverse Impacts are Likely.

Historically, privatization measures have resulted in adverse social impacts such as increases in consumption and alcohol abuse problems. During consideration of privatization in the state of Virginia, a work group to assess the potential impact of privatization on consumption and alcohol-related harms; and to identify strategies to mitigate those harms was formed to review the research.^[34] In a September 2010 presentation, the work group recommended the following measures if the state decided to privatize its state alcohol business:

- Limit the number of outlets
- Restrict marketing
- Zoning restrictions
 - Limit proximity to college/university campuses
 - Limit clustering, especially in high crime neighborhoods
- Limit days and hours of sales
- Increase excise tax
- Increase enforcement activities
 - Increase number of ABC Agents (compliance checks)
 - Other (e.g., stronger enforcement of drinking and driving laws)
- Increases prevention efforts

“The Community Preventive Services Task Force recommends against the further privatization of alcohol sales in settings with current government control of retail sales. This finding is based on strong evidence that privatization results in increased per capita alcohol consumption, a well-established proxy for excessive consumption.”^[35]

Thecommunityguide.org/alcohol/privatization.html

If you look at the Washington privatization measure, only one of these recommendations was included: increased taxes (called “fees”). The number of outlets and days/hours of sale were increased; marketing restrictions were substantially loosened; no additional zoning restrictions were included; neither enforcement nor prevention efforts were increased. It is possible that the large price increases will blunt some of the other social impacts; only time will tell.

How did I-1183 change the marketplace?

Dramatic changes were made to the marketplace for wine and spirits throughout the entire system of tiers.

“The second major reason that led us to our final decision is the impact of I-1183. We have seen a massive decline in retail sales, now that liquor is everywhere, the majority of people do not make the extra stop to buy their wine at the local wine shop.”^[36]

Letter to customers of Kent, Washington wine bar and shop, December 2013.

Wineries: Most wineries are too small to be impacted by major market changes.

Washington is the second largest producer of wines in the US and has over 700 wineries. But most of these are small, meaning they produce less than 5,000 cases per year and are sold locally or in the Pacific Northwest. In an article by the Kitsap Sun, the author notes that small wineries are unlikely to be affected by the measure because they sell their product directly to consumers or through wine clubs. Such wineries are too small to be viable in a major market because their supply is very limited. However, the state control system did provide a pathway to commercial viability in larger markets for some smaller wineries. Prior to Measure 1183, Washington State stores sold some wine products. To be sold in the 328 Washington stores, a winery needed to go through a listing process in order to be available in the state store system. Going through one listing process didn't require investment in sales staff and it was a way to get a product to all parts of the state. Now these wineries must go to major chains and independent grocers.

California Wine gained some advantage. Most of the wine sold in the US is from California wineries. A recent article on the wine market, using data from the Wine Institute, indicated that 57% of the wine sold in the US is from California. Some wine aficionados have complained that privatization accelerated the dominance of California wine.^[37] Typically, large grocers negotiate volume-based price agreements with large wineries, most of which are located in California. Since I-1183 eliminated the ban on volume discounts, it seems likely that retailers are favoring wines that sell in high volume. In addition, grocers had to clear off shelf space for spirits and many wineries felt they were the ones to go. Sean Sullivan, founder of the Washington Wine Report, was quoted as saying the overall selection has gone down.^[38] The new ability to offer volume discounts, deal directly with manufacturers and have a central warehouse also changed the competition to favor large operators who deal with large wineries. The big chains and the big box liquor stores have the ability to offer deep discounts that small wineries and small wine shops can't.^[38]

While it seems likely that Washington-based wines as a whole have been somewhat disadvantaged by the Measure, the independent grocers have found a niche for local wines. According to Jan Gee, President of the Washington Food Industry Association, because retailers can now work directly with a winery, the smaller stores are able to feature local wines that big box stores do not carry.

Distilleries: Before 1183, craft distilleries were a growing business. In 2008, a craft-distillery law was passed to allow tasting rooms and some self-distribution. The number of craft distilleries increased from 0 to 40 in four years. Like wineries, most were very small. The original distillery, called Dry Fly, has built up a very loyal clientele and the customers liked the extra convenience of finding the product in more places even though they must pay a few more dollars. However, other situations were more serious. A company called broVo spirits succeeded in getting their products listed by the Liquor Board in October 2011. As a result, they produced 200 cases of 5 different products for sale in state stores. On November 10, 2011, the Board canceled their order leaving the distillery with hundreds of cases of product and no sales. Another example involves an Oregon distiller that supplied products throughout the Northwest. In an interview with the owner, Ron Dodge, stated he lost \$4.5 million in revenue – about 50% of sales – after 1183.^[39]

“When 1183 passed big businesses like Total Wine and BevMo! — which offer one-stop shopping for beer, wine and spirits — moved into the state. The majority of their wine inventory comes from California, making it hard for Washington wineries to compete for shelf space because they can’t offer the same bulk discounts.”

Hugh Remash, owner of Eagle Harbor Wine Co.^[38]

Conclusions

- 1. The citizens of Washington did not reap large benefits from privatization.** It is important to distinguish between consumers of distilled spirits from the citizens of Washington State. While those who regularly purchase distilled spirits got some greater convenience, they are a very small portion of the general public. For the general public, the convenience was not a significant benefit as they do not drink, do not drink spirits or drink such products infrequently. While consumers got additional convenience, it came at a high price. From the first day of implementation, spirits prices were 12% higher than before; and, Washington state's prices were among the highest in the nation before privatization. The public did gain a short term benefit from the sale of assets and one-time fees, but whether that is truly a benefit is a more of a long term question. Since assets generate revenue, the sale will only be of benefit if the new "fees" generate the same or more revenue in the long run than the old system. The "fees" have already been reduced by the legislature and there is great pressure to do more. And, the Measure itself reduces the distributor "fee" from 10-5% starting in 2014. Finally, the public did not get additional revenue for local law enforcement of \$10 million. This fund was effectively voided by the state legislature leaving local governments with the same amount of liquor revenue they had before Measure 1183. The \$10 million did go to the state for its other public budget needs.
- 2. Although it is too early to assess social impacts, the measure was not constructed in a way to limit adverse consequences.** Washington, like the rest of the nation, has experienced a long term downward trend in underage drinking and drunk driving. One would not expect these trends to be instantly reversed. However, a gradual deterioration is possible given that the privatization was structured to loosen or eliminate those regulations known to reduce problems. The one exception is the high taxes and fees. The resultant prices are so high that they may very well curtail social problems. But, early data on youth attitudes toward alcohol, theft and emergency room visits is disturbing.
- 3. The primary beneficiaries of the Measure were Costco and other large, national retail grocery chains.** This was fully intended. Large retail chains gained the ability: to sell spirits in a lightly regulated environment, to sell wine in a deregulated environment, to operate as a wholesaler without paying wholesale license or sales "fees", to by-pass the distributor in purchasing wine and spirits, to purchase wine and spirits at discount based on volume. These major benefits were written into the measure and are now law.
- 4. Immediate negative impacts to business primarily hit small operators who could not compete against large national chains.** Because the major chains are legally able to deal directly with suppliers and negotiate deep discounts for high volume purchases, they are able to undercut small liquor stores, independent grocers and independent restaurants/bars. Many of the liquor stores went out of business. And, ultimately few may survive. Independent grocers have found a niche in selling local wine products which may help their survival.

5. **The measure resulted in a market dominated by large, national chain companies not a “free market” that maximizes opportunity and competition which in turn results in innovation, efficiencies and low prices.** While the campaign championed “free market values “, it was really designed for a market dominated by large, national companies. That is basically what happened. It is especially striking that the wholesale market went from a state monopoly to a duopoly where two companies have 93% of the market!
6. **The Measure was designed to squeeze the wholesale tier by saddling distributors with a 10% sales “fee” as well as a requirement that they pay for any shortfall in a targeted revenue number in the first year of operation.** No retailers were required to pay any of these “fees” even though they were granted the ability to perform the functions of a wholesaler. The wholesale marketplace quickly evolved into a “duopoly.” The fact that the Measure was designed to disadvantage the wholesale tier probably contributed to the fact that small, local or regional companies have only a small part of the business and have difficulty competing with the large chain wholesalers.
7. **The Measure cut off avenues to greater market success for small distilleries and wineries.** State stores represented an avenue to get small wine and spirit products greater visibility and sales for those without a large sales staff or advertising budget. It is unlikely that small, local suppliers will have much opportunity to sell to large chains as their wine and spirits are purchased directly from suppliers and are more likely to be out of state products. A somewhat new opportunity was created by allowing independent grocers to work directly with suppliers to feature local products.
8. **Law enforcement was immediately confronted with rampant theft of spirits from grocery stores and no new resources to deal with this issue.** The high prices and lack of attention to security spawned organized crime rings that favored theft of spirits products. The widespread availability of spirits also seemed to encourage theft by underage youth. This problem is likely to be mitigated as stores develop more anti-theft measures and the Liquor Board enforces a new law aimed at those that refuse to protect the product.
9. **Measure 1183 illustrates the importance of using a true public process to craft legislation.** The League of Women Voters’ work on privatization suggests a need for a more thoughtful approach to privatization efforts that takes into account the public’s interests. Likewise, comprehensive research on alcohol privatization can provide sound advice on ways to minimize social harm if privatization is desired. Finally, public processes provide opportunities for input from all stakeholders not just certain special interest groups. While it would be naïve to say that all stakeholders have equal access in any legislative process, few have over \$20 million to devote to a ballot measure. It should be no surprise that 1183 granted major benefits to some and not others. Washington will continue to deal with problems created by this measure for years to come.

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About the Author

The author of this paper is a former alcohol regulator. From 1996 to 2003, she was the executive director of the Oregon Liquor Control Commission. She left that position to work for Oregon Partnership in the non-profit field of alcohol abuse prevention, specializing in the reduction of underage drinking. As a prevention advocate, she gained an increased appreciation for the value of alcohol regulation and its effectiveness as demonstrated by credible research.

In 2007, she began development of the “Campaign for a Healthy Alcohol Marketplace.” She became concerned that few people really understood alcohol regulatory systems in the United States and how they work to reduce alcohol consumption and attendant problems. She realized that even as a regulator she did not entirely understand many of the complex regulations that govern the alcohol market. The concern was that important regulations could be lost merely out of ignorance. Her aim with the “Campaign for a Healthy Alcohol Marketplace” is to educate those involved with alcohol issues about the important role these regulations play.

This report is one of several reports available free of charge on the following website: www.healthyalcoholmarket.com. Other reports include: “The Danger of Alcohol Deregulation: The United Kingdom Experience” published in September, 2009; “The High Cost of Cheap Alcohol,” (2011), “Issue Briefs for States: Brief Explanations of Common Alcohol Regulatory Issues Facing State and Local Communities.” (2014 version of this annual publication). A monthly newsletter provides readers with short, easy to read synopses of more current issues. In addition to these publications, she has produced numerous PowerPoint presentations and articles. While materials are copy written, they may be downloaded and copied as long as they are not altered without the author’s permission.

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