The PA State Monopoly on Wine & Spirits:

A Systemic Failure

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Introduction & Background

The prohibition of alcohol by the federal government was a disastrous failure. It caused the emergence of a highly lucrative black market for moonshine, with violence and crime to ensue in the fight for these profits. Admitting failure, the government put into law the 21st amendment repealing prohibition in 1933. The repealing of prohibition handed the power back to the states to decide how to deal with the situation. Just four days after the repeal of prohibition, the Pennsylvania Liquor Control Board (PLCB) was founded and has controlled the wine and liquor markets in PA ever since. The reach of the PLCB stretches to every facet of the wine and liquor industries, from their website: "The Liquor Control Board controls the manufacture, possession, sale, consumption, importation, use, storage, transportation and delivery of liquor, alcohol and malt or brewed beverages in the Commonwealth."[1] The State monopoly of wine and liquor in PA has led to many negative consequences for the average citizen. Some of these consequences are easily seen, like the high prices and limited selection in State stores, but many of the consequences are invisible to the untrained eye; an example is the losses incurred on society because of misallocated capital and labor. It is mostly this "unseen" consequence and others like it which I will discuss. Most of these "unseen" consequences are caused by systemic problems within the State Monopoly system and cannot be managed, controlled or fixed. They are inherent to the system itself and are inseparable from the State monopoly, despite its attempt to "run like a business". In spite of the costs to society of having a State monopoly, the PLCB has managed to remain intact thanks to the political influence of those few who benefit from the State monopoly, unions and politicians (Bootleggers), and religious/social groups which do not support the rights of citizens to use alcohol on moral or religious grounds (Baptists). Throughout

[1] **PLCB Website - http://www.lcb.state.pa.us/**

this paper I will use the words of Ludwig von Mises and Murray N. Rothbard to guide my theoretical argument against State monopoly and bureaucratic control. Mises and Rothbard correctly foresaw the systemic problems of State-run organizations which render them, not only inefficient, but harmful for the taxpayer and consumer. Mises and Rothbard successfully predicted all of the effects of State monopoly that modern economists have found while studying the various State monopolies on alcohol in ‘control states’, and in fact have also anticipated broader impacts of the State-run “business” which modern economist have not yet discovered. This is partially because these specific impacts, like the misallocation of labor and resources, do not lend themselves to quantitative measurement because they represent the difference between the current state and the potential state. The goal of this paper is two-fold: 1) to point out the systemic problems which have doomed to failure the PLCB since its inception, and 2) to show homage to, and to elaborate on, the contributions of Mises and Rothbard to the study of the bureaucracy and organizations run by the State and the inevitable effects which they bring about.

Systemic Problems: Artificial Prices and Wages

One of the “unseen” problems with State monopoly is the use of artificial prices and wages, which in turn cause a misallocation of labor and capital. For the purposes of this paper it is unimportant to discuss whether prices are higher in ‘Control States’ than in ‘Non-Control States’[2]; instead in this section I will discuss how the use of artificial prices/wages is a necessity of all State controlled agencies and inevitably causes the misallocation of resources, whether artificially high or low it makes no difference. This particular problem associated with government run enterprises is best expressed by Rothbard:

> "No government enterprise can ever determine prices or costs or allocate factors or funds in a rational, welfare-maximizing manner. No government enterprise can be established on a “business basis” even if the desire were present. Thus, any government operation injects a point of chaos into the economy; and since all markets are interconnected in the economy, every governmental activity disrupts and distorts pricing, the allocation of factors, consumption/investment ratios, etc." (Rothbard)

In privately-owned business, prices and wages are determined by voluntary exchanges on the market. These prices/wages are arrived at thru subjective valuation. Every time a customer comes in the store and purchases an item at the ticketed price, they are demonstrating the fact that they value that product more than they value the cost. In a competitive market these subjective valuations form the demand for these products and inform the seller what price he can ask for his products. Entrepreneurs who are successful are the ones who are able to predict in advance what the profit-maximizing price of their products will be, given the subjective

[2] In the literature on the subject, states which use a State Monopoly to regulate the Alcohol industry, such as the PLCB, are known as ‘Control States’ and thus State’s without a State Monopoly are known as ‘Non-Control States’.

valuations of his products by his potential consumers. This system of price determination is entirely absent from the market for wine and liquor in PA because of the existence of the PLCB. As noted in Simon (1966) the avg. price of alcoholic beverages in 'control states' was less than the avg. price of alcoholic beverages in non-control states. Simon attributed this to the nature of government controlled enterprises to assign prices based on 'fairness' in an attempt to keep the State monopoly in place. These results were refuted by Whalen (1967), when he countered Simon by stating that such discrepancies existed only because of fair trade laws, and that in states without price maintenance regulation the avg. price was actually lower than in 'control' states. In either case, it is clear that the PLCB arbitrarily assigns a 'fair' price to charge for its products given its costs, with some percent of markup to allow for some degree of profit. The PLCB thinks that it can set prices to some percent above costs; however this assumes that costs are arrived at objectively. Costs, however, are not an inherent fact of the world. "Costs are a phenomenon of valuation", Mises wrote,

> "Costs are the value attached to the most valuable want-satisfaction which remains unsatisfied because the means required for its satisfaction are employed for that want-satisfaction the cost of which we are dealing with." (Mises 1949)

Subjective decisions are made between various options throughout the business planning and production process, and the final cost comes in to form over time based on the value of those opportunities passed over. Costs are not the same for all entrepreneurs in a market, and this is why it's an error for State organizations like the PLCB to act as such. It is clear that in PA, alcohol prices (wine and liquor specifically) are not reflective of the scarcity or subjective valuations of these goods but are instead decided politically. Prices are kept from becoming too high so as to avoid uproar from the consumers and to allow the perpetuation of the State monopoly and the revenues it guarantees the state treasury.

It is the same case for wages; they are not bound by market forces and end up being decided on politically, and are not reflective of the scarcity or subjective valuations of these types of workers. Recent research indicates that these artificially high wage levels are maintained by capturing part of the monopoly rent in the form of implicit taxes (Benson 2003). The presence of extreme unionization further brings to light the manner in which wage/benefits have been manipulated to unsustainable levels and how the State works to create dependent constituents whom will support the government entity. What emerges is a wage rate and level of benefits that is not found in any other retail industry, which is supported by a large workforce of unionized bureaucrats who will fight privatization at all costs in order to protect their artificially high wages and benefits. These artificially high wages and benefits lure workers to the PLCB. In effect, the high compensation tells potential workers ‘This is where you are needed, there is a scarcity of this kind of worker and because of that we value you greatly’ however these signals are false because they are not brought about by market exchange and competition but instead by government coercion and taxation. They mislead the worker, and draw them into the bureaucracy, whereas if it were not for the PLCB with its artificially high compensation then these workers would’ve been drawn into productive industries where their wages would have indicated a true shortage/high valuation of workers and would’ve been put to productive uses demanded by the consumer. Like much I’ve stated in this paper, this argument is stated much more succinctly by Rothbard:

> “For (*a*) the government will decrease production and living standards in the society by siphoning off potentially productive labor to the bureaucracy; (*b*) in using confiscated

> funds, the government will be able to pay more than the market rate for labor, and hence set up a clamor by government job seekers for an expansion of the unproductive bureaucratic machine; and (*c*) through high, tax-supported wages the government may well mislead workers and unions into believing that this reflects the market wage in private industry, thereby causing unwanted unemployment." (Rothbard)

Rothbard makes mention of the use of taxes in order to support the artificially high wages, and in the case of the PLCB this holds true as well. The PLCB uses implicit taxes, a method of adding the tax into the cost of the product and never showing the actual tax rate on receipts, and this allows the PLCB to add an extra 18% alcohol tax onto all products relatively unnoticed by the consumer. This allows the PLCB to hide its inefficiency, and is thus able to support the artificially high compensation levels by using taxation in part to offset it.

An interesting theory of Rothbard's, part (c) of the quote above, is that these artificially high compensation packages may trick workers and unions into thinking that it reflects the 'going rate' in the private industry. This could cause these individuals to decide to remain unemployed at lower wages because they have been led to believe that this higher wage/benefit level is attainable. In effect, the State monopoly can cause unwanted unemployment by tricking non-monopoly employed workers into thinking they are being exploited at lower wages though in actuality they are earning the market rate. It's easy to see how the artificially high compensation of the State stores can cause an unwarranted rise in expectations, which in turn can lead to more people choosing to remain or become unemployed because of these expectations.

Systemic Problems: One Size Fits All Policies

Next, I will discuss how the functioning of the State monopoly has lead to various "one size fits all" problems with the State stores, and the alcohol license system, which would not have occurred in a competitive market for wine and liquor. Central planning, whether to run an entire country or simply – in this case – the market for wine and liquor, is a 'top-down' system of governance which doesn't allow for independent owners who would normally decide on these issues for themselves in the process of competing with other local owners, and instead these decisions are imposed. "Moreover," Rothbard wrote,

> "government enterprise, basing itself on coercion over the consumer, can hardly fail to substitute its own values for those of its customers. Hence, artificially standardized services of poorer quality—fashioned to governmental taste and convenience—will hold sway, in contrast to those of the free market, where diversified services of high quality are supplied to fit the varied tastes of a multitude of individuals." (Rothbard)

Now I will explain some of the specific instances of how Rothbard's theory has played itself out in this case.

One of the most significant problems with the top-down governance style is evident in how the PLCB handles alcohol licenses. "A legislatively mandated "quota" system limits the number of licensed on and off premise beverage alcohol businesses. This quota is based on a ratio of one retail license for every 3,000 inhabitants within a municipality and one wholesale license for every 30,000 inhabitants of a county."[3] What this quota system causes is a government restriction on entry into the restaurant/bar industry. This quota system based on population causes a barrier to entry, and this successfully prevents competition from

[3] **PLCB Website - http://www.lcb.state.pa.us/**

entrepreneurs who are willing and able to compete but are prevented from doing so because of the State's quota. If this arbitrary limit on the number of licenses were lifted then we would see more competition in this market, and we would see bars/restaurants who are poorly meeting consumer demand fall by the wayside as better businesses overtake them. As of present, shoddy businesses are able to stay in business because they, in effect, have been granted a monopoly privilege to operate an alcohol distributing business in their area and it is illegal to compete with them if their county's 'quota' is already filled. The only way to prevent 'geographic monopoly grants' is by severing the connection between alcohol licenses and population, and allow an unlimited amount of alcohol licenses which would force these businesses to compete and 'stay on the ball'.

The State-wide policies have caused all stores to have uniform inventory, which effectively makes it illegal for PA citizens to purchase any brand of wine or liquor which is not 'sanctioned' by the State (since interstate purchasing is illegal). The PCLB maintains a product list of all beverages that can be found in the 621 state owned "Wine & Spirits" stores, and this list includes the statewide price for each product[4]. If a wine or spirit is not on the list of registered brands, then it cannot be bought or sold in Pennsylvania[5]. It is due to this method of 'registering brands' that the PLCB is able to manage inventory in a top-down approach. The actual management of this 'registered brand' list is influenced primarily by political factors. This is in stark opposition to how inventory selection would work in a privatized market where various retailers compete with each other in order to best meet the consumers taste and preference, with a bottom-up approach at inventory selection. These tastes and preferences vary

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[4] PLCB Website - http://www.lcb.state.pa.us/plcb/cwp/view.asp?a=1334&Q=546542&plcbNav=|32366|

[5] One notable exception, PA vintners are permitted to sell non-listed wines at their winery and at a maximum of four 'satellite' locations. There have been interesting developments overturning State laws forbidding direct interstate sales of wine to their citizens; however it is outside the scope of this paper. See Supreme Court's May 2005 ruling on *Granholm v. Heald* for more information.

from place to place and this would lead to, for example, stores in Pittsburgh likely having a different selection than stores in Kutztown, PA, and those stores having a different selection still than those in Grove City, PA. With the ‘one size fits all’ approach taken by the State, consumers are forced to take what they can get and are only allowed to consume those beverages which the State has put on ‘the list’.

The State-wide policies have caused inconvenient store hours. It is well known in PA that State stores close at a relatively early time, and some days they are not open at all. An example is that only 10% of all the State stores are open on Sundays as part of a pilot program which has only been around a few years, prior to that Sunday sales were illegal. In a privatized market, stores would have to compete with one another to find the preferable store hours suited to their consumers' preferences. Again, store hours would likely vary from area to area. An example would be that perhaps wine and liquor retailers in Philadelphia would sell 24/7 while stores in rural areas of west Pennsylvania may close much earlier.

The state-wide policies have reduced revenues for the State; by requiring the same prices to be charged in every store. With the state-wide price system the State stores are literally leaving profits on the table. In some areas prices should be decreased in order to remain competitive with bordering states which have less alcohol taxes in order to prevent some of interstate alcohol purchasing that goes on at present. However, this would likely cause problems with the social groups which oppose alcohol consumption, because then the PLCB would see an increase in purchases, though this increased purchasing wouldn't necessarily mean increased consumption because the beverages were previously being bought out-of-state. Additionally, this situation could conceivably run into an infinite regression problem; whereby citizens drive to the discount stores and causing ever more counties to have to reduce prices because all their customers flock to the cheaper stores. This is evident today with the only exception to the "one state – one price" rule, which is the outlet State store located in South Philadelphia which sells old products, or cheaper for some other reason, and has become the best-selling store in the State by stealing customers from other nearby 'regular' State stores.

Another example of the problems caused by the use of State mandates to make decisions is evident in the way the PLCB has placed State stores around PA. The PCLB rations the number of retail stores based on population, and this has resulted in a grand total of 621 State stores in a state of more than 12 million people. This works out to 1 store for every 15,995 PA citizens over the age of 18[6]. This kind of apportionment can hardly be deemed 'convenient'. Quite the contrary, 27% of all counties have only 1 or 2 State stores – or 18 out of the 67 counties[7]. I doubt average citizens or restaurant/bar owners consider it convenient when they have to drive several hours in order to make a wine or liquor retail purchase. It is safe to say that to some degree, there is the wrong number of stores, located in the wrong areas, compared to what there would have been had these decisions been left up to entrepreneurs and consumers, as would happen in a privatized market, as opposed to how these decisions are made at present by politicians and bureaucrats.

Some may argue that these qualitative problems are fixable, and all that is required is citizen suggestion. What they have not realized is just how many suggestions we would be dealing with. In a competitive market, every purchase by a consumer is in a way a suggestion. A purchase at Store A will tell Store A's owner that there are certain features about his place of business that the consumer preferred over other aspects of nearby Store B. This is the case for an incredible amount of attributes about the store, including prices, service, inventory, store hours,

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[6] **PLCB Website - http://www.lcb.state.pa.us/**
Census Website - http://quickfacts.census.gov/qfd/states/42000.html
[7] **PLCB Website - http://www.lcb.state.pa.us/**

location, décor, etc. In order for the State stores to be responsive to consumer suggestion (purchasing is synonymous in this case with suggestion) then they would have to reverse the entire way in which they govern. A central board that presides over all Stores in the state cannot be responsive to consumer suggestion in regards to all issues. “Of course”, Mises wrote,

> “every citizen might have the right to suggest some changes in this immense system of regimentation. But the way from such a suggestion to its acceptance by the competent supreme authority would at best be as far and onerous as the way is today from a letter to the editor or an article in a periodical suggesting an amendment of a law to its passage by the legislature.” (Mises 1944)

Systemic Problems: The Service Motive

Next, I will discuss the effects of a government agency "running as a business". When a government agency attempts to operate like a business, and yet is not beholden to profits like a private business, it instead uses what is known as the 'service motive' which transforms the organization to a bureaucracy. The most significant problem of endorsing the service motive is the fundamental proneness to inefficiency of bureaucratic control and the lack of progress due to the non-existence of the profit incentive to compel would-be entrepreneurs to attempt risky potential business moves. By its nature, bureaucracy is a static method of management. Bureaucracy is not intended to be the management style of rapidly changing, innovating, and adapting organizations. Bureaucracy is the form of management ruled by dictum. Bureaucrats are handed their budget, and are told to allocate resources according to these pre-selected goals and are thus unable to 'stray from the plan'.

> "Since we are in a position to survey decades of State and socialist endeavor, it is now generally recognized that there is no internal pressure to reform and improvement of production in socialist undertakings, that they cannot be adjusted to the changing conditions of demand, and that in a word they are a dead limb in the economic organism." (Mises 1920)

The problems with bureaucracy and the service motive have become evident in the form of stalled progress in the industries related to the wine and liquor markets and also accounts for much of the cost-control problems. This point is well emphasized in the following quote:

> "The virtue of the profit system is that it puts on improvements a premium high enough to act as an incentive to take high risks. If this premium is removed or seriously curtailed,

> there cannot be any question of progress. It is vain to ask an entrepreneur to embark, in spite of the absence of a profit incentive, on all the improvements which he would have put to work if the expected profit were to enrich him. The free enterpriser makes his decision on close and careful examination of all the pros and cons and on a weighing of the chances of success and failure. He balances possible gain against possible loss. Either loss or gain will occur in his own fortune. This is essential. Balancing the risk of losing one's own money against the government's or other people's chance for profit means viewing the matter from a quite different angle." (Mises 1944)

What Mises describes here is how workers in a bureaucracy are fundamentally unable to function as entrepreneurs. Without the potential for profit there is no incentive to break from tradition to possibly make an improvement since there can be no cost/benefit analysis when the capital advanced forward for this entrepreneurial endeavor is not one's own. Sure, government bureaucrats can feign 'entrepreneurial' and pursue innovative ideas to great expense, however the gains/losses are with someone else's money and this makes it impossible to rationally do cost/benefit analysis. It's impossible to determine what investments are worthwhile and those which aren't. Without "skin in the game" there can be no balancing of risk/reward, and without the lure of personal profits there is no drive to improve.

Critics will often say that the solution to this problem is simply to hire businessmen to run these nationalized industries, and that this appointment alone will change the motives of the organization. Mises challenged this argument as well:

> "Still, with his entry into communal activity he ceases to be a merchant and becomes as much a bureaucrat as any other placeman in the public employ. It is not a knowledge of bookkeeping, of business organization, or of the style of commercial correspondence, or

> even a dispensation from a commercial high school, which makes the merchant, but his characteristic position in the production process, which allows of the identification of the firm's and his own interests." (Mises 1920)

Mises correctly saw that it is not solely a man's education and experience which enables him to operate an organization efficiently. What is more important is the institutional framework which the businessman operates within. This is the principle at the core of Mises's argument against collective ownership of the means of production. The Soviet Union could have put the best entrepreneurs, the best accountants and the best penny-savers on its central planning board, and still it would not have mattered. What matters is the institution which the entrepreneur, accountant, and penny-saver are working within. As soon as an individual is placed into a 'publically owned' organization they become a bureaucrat and are unable to act as an entrepreneur at the same time. Without the profit motive there can be no entrepreneurship.

Conclusion: Can the State Monopoly live up to its promise?

Throughout this paper, I have presented the case that the PA State monopoly of wine and liquor has been a 'dead man walking' since day one. There are systemic problems with the State-run business which make it fundamentally unable to maximize revenues, unable to meet the qualitative preferences of consumers, prone to ever-increasing inefficiency, and in actuality ends up harming those it seeks to serve by causing capital and labor distortions with far-reaching ramifications which burden PA citizens financially as well as at the broader level by hindering general economic progress. Can the State Monopoly live up to its promise? I will judge the PLCB on its own terms:

> "The mission of the Liquor Control Board is to regulate the alcohol beverage industry in a fair and consistent manner; provide the best service to its customers through modern, convenient outlets, superior product selection and competitive prices in a controlled environment; and to provide factual information on alcohol and its effects through a comprehensive alcohol education program."[8]

I would summarize the main goals of the PLCB as 1) maximize revenues for the state, 2) provide "superior selection", convenience and competitive prices and 3) limit consumption by providing alcohol education in order to reduce 'externalities' such as DUI, underage drinking, and drunken disorderly.

Revenues cannot be maximized by the PLCB due to spiraling cost problems brought about by problems of inefficiency due to the nature of bureaucratic control. Without the profit motive, or private ownership, there are no incentives to make potentially risky decisions for the sake of cost cutting. Being a monopoly, the PLCB has no drive to cut labor costs and this has

[8] **PLCB Website - http://www.lcb.state.pa.us/**

allowed the Union wages and benefits to escalate to unsustainable levels, which have only been offset by the high levels of taxation. Additionally, the PLCB price list and registered brand list causes revenue-loss due to interstate purchasing either for cost savings or simply to buy products which aren't allowed to be sold in PA.

There is no doubt that retail stores would be more convenient and offer 'superior' selection in a privatized market. Qualitative factors like inventory selection are affected by the state-wide registered brand list which causes product selection to be far less responsive to consumer demand and instead hinge on political factors. The rationing of State stores causes severe inconvenience in how they are arbitrarily placed based on population, causing 27% of counties in PA to only have 1 or 2 state stores[9]. The State mandated store hours cause inconvenience in areas such as big cities where there would most likely be 24-hour retail stores in a privatized market. The current quota limit on alcohol licenses for bars and alcohol serving restaurants acts as a government grant on monopoly in a given area. It prevents would-be entrepreneurs from competing with current businesses if the 'quota' is already met. The government, by instituting a quota system, has erected a barrier of entry into the bar and restaurant market which works against innovation and improvement and instead empowers the status quo; hindering entrepreneurship and improvement in the industry by making competition illegal. The prices charged by the PLCB are greater than those found in nearby states which aren't State-controlled. Again, prices haven't been the focus of this paper so I won't languish on this point. What can be said about prices is that they are arbitrarily set, and are artificial in nature and that this – like a stone thrown into a pond – causes a ripple of distortion in the marketplace. If prices were to rise in a privatized market it would be a result of increased costs due to improved qualitative factors such as more convenient and expensive store locations, more

[9] **PLCB Website - http://www.lcb.state.pa.us/**

specific and tailored products, longer hours, etc. These choices would be made by entrepreneurs battling one another for the consumers, and ultimately, the consumer would have the last say in what factors are more important.

What I have not yet discussed is how the PLCB fails in its other goal, to limit consumption and reduce externalities, and yet it fails even in this regard as well. I did not feel it necessary to debate it in great detail in this paper because it is in this area which I defer to modern empirical minded economists. It tends to go against common knowledge that despite high prices and the multitude of qualitative issues with the State stores that somehow consumption levels could be maintained, however that's exactly what a number of authors have been indicating in recent research. "In particular, findings that alcohol taxes do not reduce measured alcohol consumption very much (Sass and Saurman 1993, Mast et al. 1999) and do not reduce externalities associated with alcohol consumption (Benson et al. 2000b; Dee 1999; Mast et al. 1999; Young and Liken 2000), and that state liquor monopolies do not reduce consumption (Simon 1966; Nelson 1990) are very consistent with such analysis. For instance, Mast et al. (1999) and Dee (1999) explain that higher taxes should not have a large impact on alcohol consumption or DUI behavior because of the potential for substitution." (Benson 2003) As cited in the above quote, there are a host of predictable behaviors which consumers make in order to maintain consumption levels despite the increased prices due to taxation and labor costs, and the increased transaction costs due to the rationing of retail locations. One type of substitution is between expensive and cheaper brands. Instead of buying premium liquor or wine, consumers may instead choose cheaper versions of that same type resulting in no change in alcohol consumed. Consumers also substitute less-regulated forms of alcohol, beer, in lieu of the heavier regulated forms, wine and liquor. A third type of substitution is in regards to bulk purchasing;

consumers can buy larger packages in order to reap the benefits of the lower cost per gallon found at larger quantities. In all three cases, the rate of consumption remains unaffected despite the higher prices and transaction costs because of the rational adjustments of consumers.

In conclusion, the PLCB has failed to meet any of the three of its stated goals. Due to systemic problems, government organizations are necessarily unable to maximize revenues and will be beholden to consumer taste and preference less than a private organization. The failure of its mission is not due to mismanagement, or poorly chosen policies. These problems are inherent to the system: the use of artificial prices and wages, the use of 'One-size-fits-all' mandates which run into the 'knowledge problem', and the use of the service motive instead of the profit motive. No amount of reform, or change in leadership will rid the PLCB of these problems. The only way to get rid of the problems is to privatize. If PA citizens want better store locations, inventory more closely reflecting their tastes, store hours better suited to their preferences, and prices chosen by economic factors instead of political factors then it is a privatized wine and liquor market which they seek. Privatization will also free up labor for more productive industries and take power away from those politically connected who benefit from the current system at the expense of the PA taxpayer and PA alcohol consumer. Ultimately, in a privatized market, the businesses selling alcohol for retail or in a bar/restaurant setting would be forced, by competition, to become more responsive to consumer preferences and thus in the end would result in the consumer getting more of what they want, for less.

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