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Prohibition and Repeal: A Short History of the Wine Industry's Regulation in the United States*

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Abstract

The United States wine industry has experienced tremendous growth in the past twenty-five years. The number of wineries in the United States has grown to almost 5000, located in all fifty states, and creating over a million full time jobs. Alcohol distribution laws that hinge on the Supreme Court's reconciliation of the Twenty-first Amendment and the Commerce Clause have significantly hindered the industry's ability to expand. Current interpretations of the 21st Amendment give states unprecedented freedom to regulate interstate commerce in alcoholic beverages. The resulting regulatory diversity presents problems both domestically and internationally. (JEL Classification: K2, L5, N4)

I. Introduction

Picture yourself in the midst of a leisurely vacation in the wine country of your favorite state. Glorious weather, favorite recreational activities, good food and, of course, excellent wine make the experience memorable. You purchase some locally produced wine. After returning home, you contact a particularly well remembered winery to obtain more for a housewarming gift or to celebrate a special occasion and find, to your dismay, that the winery is not permitted to sell its products to you because you are living in a state whose regulations forbid such sales; or, that while technically legal, state requirements make the sale virtually impossible to consummate. Even if you are not versed in law, you probably share with most Americans a vague sense that this is odd. Retailers do not usually decide whether or not to sell you their products based on where you live. If asked we would likely

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agree that one state is not generally permitted to exclude products produced in other states. Unfortunately, we are mistaken and you, and the winery you had hoped to patronize, could easily find yourselves to be sadly out of luck.

Consumers are inconvenienced. Small wineries may find that complying with the myriad of regulations is far harder than producing wine. In some states it is legal to sell to in-state customers, but not to those out of state. Shipping to Maryland residents without special permits is a felony. Some states permit shipments to some states, but not others and some permit only intrastate shipments or restrict shipments to certain carriers (Wine Institute, 2008). In addition, these laws are subject to continual legal challenge and revision. Meanwhile alcohol importation policies are becoming subject to World Trade Organization (WTO) litigation. In 2007 the European Union filed charges against India for its high tariffs on alcohol imports. If the United States wine market continues its recent growth, the industry could easily become a target for similar charges since the myriad state-by-state regulations could be construed as non-tariff barriers to alcohol importation (Wine Institute, 2008).

How did we get here? The passing of the 21st Amendment also known as the repeal of prohibition) sowed seeds that have grown, in some states, into an impenetrable thicket barring the way to interstate sales of wine and seriously hampering the growth of small wineries. Nor is this simply a domestic problem. To a foreign exporter, these variable requirements have the look and feel of protectionism, regardless of their intent. By permitting states to maintain differential policies toward non-domestically produced wine, the United States may be in violation of World Trade Organization policy and other trade agreements.

II. Temperance, Prohibition and the 21st Amendment

Prohibition (January, 1920 – December, 1933) gave states hitherto unprecedented powers to control the importation of alcohol within their borders. Previously, interstate sales of alcohol were deemed to fall under federal jurisdiction because the Commerce Clause was held to delegate power over the regulation of interstate commerce to Congress in Article 1, Section 8, Clauses 1–3 of "The Constitution of the United States."

> *The Congress shall have power to lay and collect taxes, duties, imposts and excises, to pay the debts and provide for the common defense and general welfare of the United States; but all duties, imposts and excises shall be uniform throughout the United States;*
>
> *To borrow money on the credit of the United States;*
>
> *To regulate commerce with foreign nations, and among the several states, and with the Indian tribes;*

Adding to this affirmative grant of power, the dormant Commerce Clause doctrine asserts that states may not engage in economic protectionism. Specifically, they may not adopt regulatory measures that are designed to benefit in-state economic interests by

burdening out-of-state competitors (Garlough, 2005). The implementation and subsequent repeal of Prohibition changed this. Prohibition was the consequence of the ratification of the Eighteenth Amendment to the United States Constitution. The ratification was the result of more than 100 years of activism. State attempts to regulate alcohol consumption and distribution began early in the nineteenth century. Domestic use was not subject to state control because prohibiting liquor produced out-of state from being shipped into another state was protected by the dormant Commerce Clause's original package doctrine (Nielson, 2005). The package doctrine undermined the state's ability to enforce prohibition because it stated that interstate shipments of goods were not subject to state regulation until they had been delivered to the consignee and the original package had been opened.[1]

In response to these rulings the Federal government passed the Wilson Act in 1890 giving states the right to regulate all liquor "to the same extent and in the same manner as though such…liquor had been produced there." The wording of this Act specifically prohibits discrimination against out-of-state liquor sellers (Office of Law Revision Counsel, 2009). The powers granted by the Wilson Act were insufficient to ensure the ability of the states to promote temperance because the Supreme Court did not construe the Wilson Act to address importation for personal use (Neilson, 2005). The passage of the Webb-Kenyon Act in 1913 completed the transfer of authority to the states, prohibiting the "shipment or transportation, in any manner or by any means whatsoever" of liquor "from one State, Territory, or District of the United States" into another "in violation of any law of the State, Territory, or District" (Office of Law Revision Counsel, 2009). As we will see, this language is the key to the present state of affairs. Complete uniformity of alcohol regulation was obtained with the ratification of the 18th Amendment to "The Constitution of the United States."

> **Section 1.** After one year from the ratification of this article the manufacture, sale, or transportation of intoxicating liquors within, the importation thereof into, or the exportation thereof from the United States and all territory subject to the jurisdiction thereof for beverage purposes is hereby prohibited.
>
> **Section 2.** The Congress and the several States shall have concurrent power to enforce this article by appropriate legislation.
>
> **Section 3.** This article shall be inoperative unless it shall have been ratified as an amendment to the Constitution by the legislatures of the several States, as provided in the Constitution, within seven years from the date of the submission hereof to the States by the Congress.

The text of the amendment passed Congress in 1917 and was ratified by the required 36 states by January 1919, going into effect in January 1920. The amendment was repealed when the 21st Amendment, passed by Congress in February of 1933, received the necessary

[1] See Supreme Court Ruling *Brown v. Maryland* (Supreme Court of the United States,1827) clarified by *Leisy v. Hardin* (Supreme Court of the United States,1890).

state ratification on December 5, 1933. The text of the 21st Amendment to "The Constitution of the United States" is as follows:

> **Section 1.** The eighteenth article of amendment to the Constitution of the United States is hereby repealed.
>
> **Section 2.** The transportation or importation into any State, Territory, or Possession of the United States for delivery or use therein of intoxicating liquors, in violation of the laws thereof, is hereby prohibited.
>
> **Section 3.** This article shall be inoperative unless it shall have been ratified as an amendment to the Constitution by conventions in the several States, as provided in the Constitution, within seven years from the date of the submission hereof to the States by the Congress.

Note that the language used in the Webb-Kenyon Act, which prohibited alcohol shipments into states where this was illegal, is repeated in Section 2. This repetition is, from a legal perspective, particularly problematic. The original intention of the Webb-Kenyon Act (1913), which empowered states to prohibit direct shipment of alcohol to state residents, was to reinforce the Wilson Act (1890), which mandated equal regulatory treatment of domestic and non-domestically produced alcohol. The operative question is whether the two acts worked in conjunction to fully empower states to promote temperance. If this is the case then it would follow that by including the language of Webb-Kenyon in the 21st Amendment, the amendment intended to incorporate the Wilson Act and states may not legally discriminate between in-state and out-of state alcohol sales. If, however, the Webb-Kenyon Act replaced the Wilson Act, the Webb-Kenyon Act eliminated the antidiscrimination component of the Wilson Act and immunizes the 21st Amendment from the dormant Commerce Clause (Neilson, 2005). In this case, discrimination between domestic and out of state producers would be legal.

This confusion is the source of our present situation, in which states impose a variety of rules and restrictions on the sale of alcoholic beverages, from "Blue Laws" limiting days and hours of sales to the total prohibition in force in "dry" counties (Wine Institute, 2008). Because the amendment provided no parameters to limit state laws regulating alcohol importation, both states and the federal government can claim jurisdiction over alcohol regulation and the legality of state regulations are subject to legislative review and subsequent revision.

Even the legislators who drafted and ratified the 21st Amendment differed in their interpretations of Section 2 (Versfelt, 1975). Absolutists intended the amendment to designate complete regulatory control of alcohol to the states. Senator Blane, an absolutist sponsor of Section 2, explained,

> *The purpose of Section 2 is to restore to the states, by Constitutional amendment, absolute control in effect over interstate commerce affecting intoxicating liquors which enter the confines of the states… Thus, the states are granted a larger power (Denning, 2002).*

This interpretation removes alcohol importation and delivery from the dormant Commerce Clause jurisdiction. Other absolutists such as Senator Walsh, a member of the subcommittee that drafted the amendment, believed the intent of Section 2 was to protect a state's right to enforce temperance.

> *The purpose of [section two] in the resolution reported by the committee was to make the intoxicating liquor subject to the laws of the State once it passed the State line and before it gets into the hands of the consignee as well as thereafter (Versfelt, 1975).*

Both absolutist schools interpret the language in Section 2 to remove all power from federal hands.

Most members of the Congress that drafted and approved the amendment and most present-day courts espouse the "federalist" position (Versfelt, 1975). Federalists believe the amendment's intent was to protect a state's right to prohibition by decreasing federal authority over alcohol only the extent necessary to prevent federal regulation under the Commerce Clause from unduly interfering with state regulations to promote temperance. During the Congressional debate for ratification Senator Fess articulated this perspective.

> *In other words, the second section of [the Amendment] that is now before us is designed to permit the Federal authority to assist the States that want to be dry to remain dry (Versfelt, 1975).*

According to the Federalist position, the Amendment was intended to work in conjunction with the power of Congress under the Commerce Clause to strike a balance between a state's desire to regulate liquor and the federal government's authority to promote and protect interstate commerce (Versfelt, 1975).

At the state level, deliberations at the repeal conventions offer little information about their legislative intent (Versfelt, 1975). For the states, the desire to end Prohibition was paramount and any questions raised by the specific text of the Amendment were left for later clarification. This eagerness is not surprising given the increase in criminal activity and expansion of organized crime associated with Prohibition. Unfortunately, this haste has had far reaching long-term implications.

III. Legal Issues Following Repeal

A. *Consequences: The Three Tier System and Tied-House Restrictions*

Following the ratification of the 21st Amendment most states adopted a three tier distribution scheme under which alcoholic beverage producers (tier one) must be licensed by the state and can only sell to state-licensed wholesalers (tier two), who collect excise taxes from the producer and provide the states with information about the supplier and the alcohol they purchase. Wholesalers in turn sell to retailers (tier three). The three-tier system was adopted as a

reaction to the "overarching concern of keeping the criminal element, which was so prevalent in the bootlegging industry, out of the legal distribution system" (Grafstrom, 2005).

Three tier systems were usually accompanied by tied house restrictions. Tied house restrictions prohibited owners of one tier from investing in businesses of another tier, preventing vertical integration of the industry. This was a response to pre-Prohibition attempts by vertically integrated producers to sabotage state efforts to promote temperance (Durkin, 2006). Tied house restrictions were a product of the Federal Alcohol Administration Act of 1935 that mandated that a state either restrict tied houses or run the entire distribution system itself. The purpose of this act was to avoid unfair barriers to interstate competition by preventing wholesalers from keeping competitors' products from the market and interfering with retail pricing (Dickson, 2006).

To the extent that state-imposed regulations provided barriers to entry for out-of-state competitors, they provided clear benefits to domestic producers, wholesalers and distributors. Many states refused to license out-of-state producers or wholesalers to sell domestically. They also limited the number of domestic retailers. This provided a strong incentive for these stakeholders to support the current regulatory system and resist deregulation that could open their markets to competition from out-of-state entities. The American wine industry had been devastated by Prohibition although some wineries survived by producing communion wine, tonics or other permissible products (Pinney, 2005). Even if wine producers had been able to foresee the ultimate results of the 21st Amendment, the industry lacked the economic or political clout to influence the form of the legislation.

B. *Early 21st Amendment Case Law*

Early court reviews of state laws upheld the absolutist interpretation. In the 1936 case *State Board of Equalization of California v. Young's Market Company,* several wholesale importers filed suit against California for imposing a $500 licensing fee on out-of-state beer importers claiming that the law violated the dormant Commerce Clause and that the 21st Amendment did not justify that violation. Justice Brandeis, writing for the majority, concluded

> *Prior to the Twenty-First Amendment, it would obviously have been unconstitutional to have imposed any fee for that privilege. The imposition would have been void not because it resulted in discrimination, but because the fee would be a direct burden on interstate commerce, and the commerce clause confers the right to import merchandise free into any state, except as Congress may otherwise provide… The amendment which "prohibited" the "transportation or importation" of intoxicating liquors into any state "in violation of the laws thereof" abrogated the right to import free, so far as concerns intoxicating liquors. The words used are apt to confer upon the state the power to forbid all importations which do not comply with the conditions which it prescribes. The plaintiffs ask us to limit this broad command. They request us to construe the amendment as saying, in effect: the state may prohibit the importation of intoxicating liquors provided it prohibits the manufacture and sale within its boarders,*

> *but if it permits such manufacture and sale, it must let imported liquors compete with the domestic on equal terms. To say that would involve not a construction of the amendment, but a rewriting of it (Supreme Court of the United States, 1936).*

According to Brandeis' ruling, state monopoly on manufacture and sale, prohibition on importations, taxation of imports, and partial prohibition were entailed under the greater power of total prohibition. Subsequent alcohol cases that made their way to Brandeis' court were informed that the judgments of *Young's Market* applied to all of them (Denning, 2002).

C. *Judicial Evolution*

Beginning in the 1940s the courts opened the door to the challenging of "unreasonable" alcohol regulations, applying the dormant Commerce Clause to a few cases not directly related to state alcohol importation, delivery, or use. State regulations not clearly governing importation for delivery or use were subject to scrutiny for reasonableness (Denning, 2002).

In the 1960s the Supreme Court struck down state regulations concerning alcohol imports for the first time since the 1890s, marking the beginning of the trend within the courts to abide by the federalist interpretation of the 21st Amendment (Versfelt, 1975). In 1964 the Court, led by Justice Stewart, decided *Hostetter v. Idlewild Bon Voyage Liquor Corporation*. The state of New York had shut down a duty free liquor store in John F. Kennedy Airport whose existence violated state law. The owner, Hostetter, accused the state of violating the Commerce Clause by shutting down his business. In deciding the case Justice Stewart acknowledged the precedent set by *Young's Market* but insisted that the facts in this case were different because the "ultimate" destination was not within the state of New York (Versfelt, 1975). He directly addressed the conflict between the 21st Amendment and other constitutional amendments, writing

> *To draw from these conclusions that the Twenty-first Amendment has somehow operated to 'repeal' the Commerce Clause wherever regulation of intoxicating liquors is concerned would, however, be an absurd oversimplification. If the Commerce Clause had been pro tanto 'repealed', then Congress would be left with no regulatory power over interstate or foreign commerce in intoxicating liquor. Such a conclusion would be patently bizarre and is demonstrably incorrect. … Both the Twenty-first Amendment and the Commerce Clause are parts of the same Constitution. Like other provisions of the Constitution, each must be considered in the light of the other and in the context of the issues and interests at stake in any concrete case (Supreme Court of the United States, 1964).*

This ruling is the source of an alternative line of 21st Amendment cases that hold that the power of the 21st Amendment is limited by other provisions of the Constitution, particularly the Commerce Clause.

Subsequent cases explored how the Constitutional harmonization envisioned by Justice Stewart might be achieved. Courts developed tests to balance state interests against federal

interests in regulating interstate commerce (Garlough, 2005). The first case to use this approach was *California Retail Liquor Dealers Association v. Midcal Aluminum Company* (1980) in which pricing practices were challenged as a violation of the Sherman Act.[2] A case in 1984 set another important precedent limiting state regulatory power by extending the regulation of the dormant Commerce Clause into the states for the first time. In *Bacchus Imports Ltd. v. Dias*, Justice White ruled that Hawaii could not exempt locally-produced liquor from an otherwise generally-applicable twenty percent excise tax, stating

> *One thing is certain about the Amendment... The central purpose of the provision was not to empower States to favor local liquor industries by erecting barriers to competition ... State laws that constitute mere economic protectionism are therefore not entitled to the same deference as laws enacted to combat the perceived evils of an unrestricted traffic in liquor (Supreme Court of the United States, 1984).*

This ruling suggests that not only must the laws be necessary to the promotion of temperance, but that laws for in-state alcohol must be correspondingly regulatory so that the intent of the state is clearly temperance, not protectionism. This evaluation has guided the Court in deciding most subsequent 21st Amendment cases (Garlough, 2005).

The evolution of the Supreme Court's interpretation of the 21st Amendment as specifically limited by the Commerce Clause resulted in several lower court cases contesting the constitutionality of state alcohol laws that appeared to be barriers to interstate trade, particularly when the regulations prohibited interstate alcohol shipments. Most of these cases rejected non-uniform state shipping bans as discriminatory (Garlough, 2005). In 2005 the Supreme Court consolidated three cases involving Michigan and New York granting *certiorari* (calling the record of a lower court into review). In *Granholm v. Heald*,[3] the Court struck down the challenged laws. Majority Justice Kennedy joined by Justices Scalia, Souter, Ginsburg, and Breyer held that these schemes discriminated against interstate commerce in violation of the Commerce Clause. Justice Kennedy wrote, "this case goes to what's at the very core of the 21st Amendment, whether the states can decide who can sell liquor to their citizens" and "goes to the very core of the Commerce Clause" that only Congress can allow discrimination against out-of-state products (Anderson, 2007).

In reaching its decision the Court further evolved 21st Amendment law by moving away from the balance of concerns test. The Court explained that modern 21st Amendment cases have established three principles about the 21st Amendment,

> *(1) State laws that violate other provisions of the Constitution are not saved by the Twenty-first Amendment, (2) Section 2 does not abrogate Congress Commerce Clause powers with regard to liquor, and (3) state regulation of alcohol is limited by the nondiscriminatory principles of the Commerce Clause (Durkin, 2006).*

[2] According to the Sherman Act, "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal" (Office of Law Revision Council, 2009).

[3] The consolidated cases were *Granholm v. Heald*, *Michigan Beer & Wine Wholesalers v. Heald* and *Swedenburg v. Kelly* (Supreme Court of the United States, 2005a).

These principles imply that discriminatory alcohol regulations must survive the same Commerce Clause scrutiny as discriminatory state laws regulating other articles of commerce (Durkin, 2006). The Court specifically articulated that non-uniform laws were not upheld by the 21st Amendment.

A key factor in the decision was the fact that the states (Michigan and New York) were unable to demonstrate compelling reasons that would make such discrimination necessary or desirable. The Court asked the state defendants to simplify the question at hand by agreeing to base their argument on the grounds that the state alcohol laws were not forms of discrimination, discrimination meaning "treating out-of-state people differently without good reason" (Supreme Court of the United States, 2005b). The "good reasons" of concern to the states were enforcing state law regarding tax collection, discouraging sales to minors, and preventing the evasion of state alcohol regulations. The states failed to establish the validity of their expressed concerns. There was no significant evidence that the states were monitoring in-state sellers to the extent that they claimed to need to monitor out-of-state sellers. Moreover, the states could offer no evidence demonstrating that out-of-state wineries were trying to engage in unlawful activities. Justice Scalia pointed out that since 26 states allow direct shipment from out-of-state wineries, this "certainly suggests that what [the state] is arguing is not essential to the state's enforcement of its alcohol laws" (Supreme Court of the United States, 2005b). The 26 states that, at the time, allowed out-of-state direct shipping to in-state customers successfully relied on the Federal Government and the state of origin to police the direct wine shipments.

D. *Criticisms of the Three Tier System*

Changes in the nature of commerce have exposed the limitations of the three tier system. The advent of the Internet and e-commerce provides alternatives to the traditional distribution system. It also makes tied-house restrictions difficult to support. An online retailer (selling to customers) may also be an Internet wholesaler (selling to retailers). Under tied-house restrictions a producer must choose which tier it will serve. For example, it may legally sell to a consumer only if it refuses to sell to any producers, wholesalers or retail establishments in the same state (Schorske, 2000). This presents a dilemma for out-of-state producers because direct shipment may be the only viable way to generate enough demand for their product to make wholesale distribution profitable. Unfortunately, the initial decision to direct ship may make it illegal to sell to wholesalers in the same state because of the tied house restrictions that accompany three tier systems.

Currently, structural changes within the industry are helping to entrench the three tier system. The number of wholesalers is falling because recent anti-trust decisions have forced wholesalers to compete on the basis of cost. The resulting competition eliminated less efficient distributors and made the remaining distributors more anxious to maintain the market protection the current system provides. Retail systems have also become more concentrated. Retailers, therefore, are also resistant to any changes in state regulations that could increase competition in the retail tier.

Interestingly, every case involving alcoholic beverages that has questioned the constitutionality of the three tier system has upheld its constitutionality. In *Granholm v. Heald* the Court reaffirmed that under the 21st Amendment a state may implement a three tier system or any other comprehensive system of alcohol regulation as long as the system does not treat in-state and out-of-state alcohol differently (Grafstrom, 2005). The Court also upheld the right of states to regulate alcohol through the complete banning of direct shipment despite the contention by winery owners and some legal scholars that these laws create an impermissible barrier to interstate trade and are, therefore, infringements of the Commerce Clause (Garlough, 2005).

E. *Franchise Laws*

In many states the barriers to entry imposed by tied-house restrictions are reinforced with obstructive franchise laws that provide additional barriers to entry. As of 2004 thirty-three states had some form of franchise law governing the relationships between wholesalers and producers (Durkin, 2006). In some states these laws make it difficult if not impossible for a producer to unilaterally terminate relations with a distributor, regardless of the distributor's performance (Riekhof and Sykuta, 2005) and it may be possible for wholesalers to pass their distribution rights on to successors, creating a "nearly perpetual contract with a single wholesaler once distribution begins" (Durkin, 2006). In some states, once a producer has sold to a distributor, it is restricted to the use of that distributor. In some states engaging a distributor for Internet sales may tie the producer to a future relationship with that distributor if it should later decide to sell in that state through conventional channels (Schorske, 2000). In addition, the franchise laws of many states are territory laws. These laws require that the supplier designate the territories that the wholesaler will service. Frequently these territories are required to be exclusive, precluding direct sales by the producer. Even in states where the franchise laws do not require territory designation many wholesalers insist on an exclusive appointment for a particular territory (Schorske and Heckathorn, 2001). Exclusivity coupled with the difficulty in terminating franchise agreements makes retailers as well as producers vulnerable to wholesalers who may give preferential treatment to favored customers or clients (Durkin, 2006).

The rise of a national wine industry over the past three decades and the increasing use of Internet commerce have resulted in legal challenges that have forced courts to address the laws under new circumstances (Durkin, 2006). The recent Supreme Court rulings favoring the power of the Commerce Clause's anti-discrimination mandate over state regulatory freedom regarding alcohol have resulted in more legal revision but little more consistency across the states. Confusion increases as states attempt to rewrite existing regulations to achieve compliance with Supreme Court rulings while maintaining the control they have previously exercised.

F. *Direct Shipping and the Courts*

Direct shipment is increasingly popular as consumers across the country consume more wine than ever before. Increased winery tourism means more visitors who want to be able to order the wine they have tasted once they go home. Heightening this customer demand

for directly shipped wine is the Internet. Online commerce has emerged as a highly lucrative segment of the market. The Federal Trade Commission estimates that in the second half of the 1990s the amount of wine sold via the internet doubled in value and that in 2001 it accounted for three percent of United States wine spending (Dickson, 2006). Despite this trend, many states choose to isolate themselves from this growing interstate wine market.

Prior to the 1980s almost every state banned direct shipment from out-of-state wineries to in-state customers. However many states made exceptions for in-state wineries, allowing them to ship wine directly to customers via home delivery (Wiseman and Ellig, 2005). In the 1980s some states relaxed their restrictions on direct shipping by implementing reciprocity agreements with other states. With such an agreement wine can be imported to state A from state B only if state B allows wine imports from state A. By 2004 thirteen states allowed direct shipping through such reciprocity agreements, thirteen other states allowed direct shipment from all states, and twenty-four states continued to completely ban interstate direct shipping (Wiseman and Ellig, 2005). In 2002 and 2003 federal courts found such discriminatory laws in Michigan, Texas, North Carolina, and Virginia to be unconstitutional violations of the Commerce Clause and Texas, North Carolina, and Virginia opened to direct shipment from out-of-state. Michigan protested and joined with New York in petitioning the Supreme Court for *certiorari*, review of lower court cases, in the case *Granholm v. Heald*, often referred to as the direct shipping case. Since this Supreme Court ruling in 2005 of "all or nothing," states have had no choice but to reconcile their out-of-state direct shipping laws with those for their in-state wineries (Dickson, 2006). States can no longer permit domestic wineries to direct ship while banning direct shipment from out of state.

At the heart of the debate in legislative and judicial arenas is the question of public interest (Riekhof and Sykuta, 2005). Alcohol policy is one area where politics and economics are intimately connected and "history demonstrates that the economic and social consequences of alcohol regulations are notoriously difficult to predict accurately" (Wiseman and Ellig, 2003). For a discriminatory law to be enforceable under the Commerce Clause the law must meet a public interest requirement demonstrating the law advances state health, safety, and welfare. In addition to this public interest requirement, courts also require that the social gains exceed the burden on interstate commerce and that no less restrictive alternative is available to achieve the social objective. Even under this lower requirement threshold, regulations are permissible only if they promote temperance, raise revenues or ensure orderly market conditions (Riekhof and Sykuta, 2005). The direct shipping discrimination cases in *Granholm* were argued by the states as necessary means for enforcing their laws. States have failed to prove this argument in almost all cases, suggesting that these concerns are unfounded.

There is speculation that state lawmakers were less concerned with the public interest than they claimed in court. In their 2005 paper, Riekhof and Sykuta studied state distribution decisions and found little evidence that public interest factors played a significant role in determining interstate direct shipping regulations. "Indeed, the results on alcohol related arrests indicate a positive, and in the case of reciprocity a significantly positive,

effect on allowing direct shipment, counter to a public interest rationale." They also found that economic interests in both the private and public sectors appeared to "significantly affect the likelihood of regulatory change in direct shipping."

G. *Contestants to Direct Shipping Rights*

The primary defendants in direct shipping cases have been the states, but those who think they stand to incur losses from direct shipping have intervened as additional defendants. Those parties were wholesalers, such as Michigan Beer and Wine Wholesalers association, and several New York wholesalers, as well as parties that have financial ties to wholesalers, such as the New York Local 2d of the Allied Food and Commercial Workers Union, and the New York Metropolitan Package Store Association. Additional support has come from Wine and Spirits Wholesalers Association, the Beer Institute, the National Beer Wholesalers Association, state alcohol beverage regulators, and 31 attorneys general (Wiseman and Ellig, 2005). Significantly, most of these parties belong to the second and third tiers of the three tier system and stand to lose market share if direct shipment is permitted. Proponents of existing bans have consistently argued that bans on direct shipping do not inhibit competition or inflate retail prices. They argue that their statutes "discriminate against interstate commerce [only as] it advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives" (Bolick, 2000).

One explanation for the unlikely composition of the coalition joining the states is Bruce Yandle's Bootleggers and Baptists theory (Wiseman and Ellig, 2005). This theory connects the composition of the coalition of current defendants of the direct shipment ban with those who took the side of state temperance in earlier debates over prohibition. The theory describes how coalitions of public-interest advocates and private industry support social regulation that curbs competition. In recent cases various public health groups advocated on the side of the wholesaler because they explicitly endorse higher prices to curb alcohol consumption. This broader interest coalition (the "Baptists") include the National Association of Evangelicals, Phyllis Schlafly's Eagle Forum, Gary Bauer's American Values, Concerned Women for America, and the Michigan Association of Secondary School Principals on the side of the wholesalers (Wiseman and Ellig, 2005). They contended "that direct shipment made it impossible for states to enforce the minimum drinking age" (Wiseman and Ellig, 2005). However, as the Riekhof and Sykuta study suggests, the Baptist's input, which indisputably sprung from a concern over public welfare, likely has little influence on the policy of the legislatures, and it is the Bootleggers' interests that influence policy.

The Bootleggers' interest is consistent with broader "rent seeking" theories of regulation and favors regulation because they benefit from the resulting constraints on competition. Wiseman and Ellig (2005) noted that whether or not direct shipment bans actually protect wholesalers from competition is an open question. If direct shipment is a small, niche market phenomenon that has little or no effect on the wholesalers' sales or profits, then wholesaler support for the bans may legitimately be for the purpose of promoting 'responsible' access to, and consumption of, alcohol. However, there are "certain structural

features of alcohol distribution networks" that suggest "wholesalers have significant economic incentives to support barriers to direct shipments" (Wiseman and Ellig, 2005).

H. *Direct Shipping and Self-Distribution*

In the re-evaluation of state laws in the wake of *Granholm v. Heald*, priority was placed on direct shipment. However, in the process, another important tool for industry growth, self-distribution, lost ground. Self-distribution allows wineries to drive in their own vehicles and sell their wine directly to retailers. While *Granholm* did not explicitly address self-distribution there is little doubt that laws permitting in-state wineries to sell directly to in-state retailers, but preventing out-of-state wineries from making the same sales, are the types of discriminatory laws that the Court identified in *Granholm*. Some of these bills even expressed a discriminatory intent (Durkin, 2006).

For example, the Virginia Farm Winery provision allowing in-state wineries to self-distribute was rejected by the U. S. District Court in 2005. Virginia found itself in the same position as many other states, where the privilege to direct ship was retained but the right of self-distribution was lost (Virginia Farm Bureau Federation, 2007). Following *Granholm*, states that changed their laws to ban self-distribution included Louisiana, Delaware, and Kentucky. In Indiana and Wisconsin the cost of retaining direct shipping rights was specifically the loss of the ability to self-distribute to the retailer (Dickson, 2006). Both customers and retailers find themselves in a less appealing market with the loss of self-distribution. If wineries are unable to bear the burden of the distributor's cut of the wholesale price (usually 20–50 percent) then the choice is to raise prices or rely completely on direct shipping if they are unable to reduce their costs. In either case, reduced sales are likely to result.

There is also concern that permitting direct shipping to retailers by in-state and out-of-state producers "could result in thousands of new out-of-state farm winery permit holders, with no practical way for the state excise officers to verify their financial reporting or police their sales and deliveries to retailers" which would hurt legitimate state interests (Durkin, 2006). Durkin suggests that the elimination of all self-distribution both advances legitimate state interests and is consistent with the Commerce Clause. A principal concern of wholesalers is that extending the right to self-distribute to out-of-state wineries will allow the bigger brands that in-state distributors currently carry to bypass them on their way to major retailers like Costco, Wal-Mart, and Sam's Club, pushing distributors out of the market (Johnson, 2006). Projections of increasing wholesaler revenues (N.N., 2006) suggest that wholesalers' fears of being pushed out of the industry may be unfounded. However, permitting self-distribution reduces their potential market, an outcome they, not unnaturally, oppose.

IV. Conclusions

A 2003 Federal Trade Commission report found that the restrictions imposed by traditional three tier systems and direct shipping bans were not necessary to meet the core concerns of

the states but increased consumer prices and decreased selection. The report quoted economist Daniel McFadden that the restrictions were "another example of abuse of the regulatory process to protect concentrated economic interests, going far beyond the minimum regulations needed to maintain the integrity of taxation and to protect minor consumers" (Federal Trade Commission, 2003). In the Journal of Wine Economics (2006) McFadden concluded,

> *If excessive State restrictions on interstate wine shipments were eliminated, and the legitimate State interests for control and taxation were met through market innovations of the form just outlined, consumer welfare would be materially improved. Consumers would have more choices. Legitimate state interests in control and taxation of alcoholic beverages would be preserved. Traditional distributors and retailers would face modest increases in competitive pressure, but they would avoid the outraged complaints of the small but influential group of premium wine consumers.*

Other pressures on the three tier system that call its legitimacy into question come from the increasing globalization of the alcoholic beverage industry. The United States alcoholic beverage market "is one of the most regulated in the world" (Schorske, 2000). While the United States may accept the three tier system as standard, the rest of the world does not. International trading partners protest that restrictions that are not directly related to important social purposes (such as tax collection, temperance, and restricting sales to minors) should not be tolerated. From their perspective, many aspects of our three tier system unacceptably hamper efficient distribution and unnecessarily inflate shelf prices. They see our cumbersome distribution system as anti-competitive and unfairly favoring local interests, thus decreasing market access in violation of free-trade treaties. The liberalization of markets is at the very heart of these treaties and the three tier system is at odds with this objective (Schorske, 2000). European Union alcoholic beverage producers and distributors as well as our other trading partners will continue to push for equal access to the United States' market, "necessitating the removal of many of the barriers established as part of the three tier system" (Schorske, 2000). If this is correct, it behooves us to be proactive and reform our alcohol distribution system.

In addition to international concerns, a 2003 Federal Trade Commission report concluded that the alcoholic beverage industry has "the most expensive distribution system of any packaged-goods industry by far with margins more than twice those in the food business" (Federal Trade Commission, 2003). The report estimates that the three tier distribution system forces an eighteen to twenty-five percent mark-up on wine (Dickson, 2006). Additionally, by limiting the number of businesses issued permits at each tier, the state can control the types and amounts of alcohol sold within its borders. This control can be used to increase the state's tax revenue by shifting the mix of products consumed to maximize the resulting tax revenue (Garlough, 2005). The legally acceptable argument is that these burdens to the market are outweighed by the benefit to the state's core concerns. However there is little evidence that contemporary forms of the three tier system promote these core concerns.

The current regulatory patchwork is inefficient and unwieldy for domestic producers and consumers. It also increases the probability of foreign trade disputes. Foreign markets may be reluctant to accept U.S. wines because of the extraordinary complexity

involved in selling their products here. Consistency (of regulation) through compromise (by states) could yield the benefits of uniform regulation without unduly restricting states' rights in this area. An initiative by the Wine Institute advocates model legislation that would provide consistent direct shipment regulations by amending existing alcohol control legislation at the state level. Until that happens, legal challenges will continue to incrementally change state policies and circumscribe the operation of the three tier system and related regulations. Unless the unlikely event of federal legislation is realized and withstands judicial review, the current system appears to be entrenched for the foreseeable future.

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