



Giving Away the Store

A Preliminary Analysis of the Corbett Administration-commissioned Liquor Privatization Analysis

By Roland Zullo & Stephen Herzenberg • November 2, 2011

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Overview

A study commissioned by Governor Tom Corbett's administration contains several flaws that cast doubts on its findings in support of privatizing Pennsylvania's wine and spirit stores. Based upon an initial review, the study by Public Finance Management (PFM) appears to inflate the upfront revenue a sale would fetch, ignores the privatization experiences of other states, overstates public operational costs of the current system, and presents an overly optimistic estimate of revenues under a privatized system, among other concerns. The study also recommends a privatization approach that may reduce access to wine and spirit stores for some rural consumers while contributing to more alcohol-related social problems across the Commonwealth. Finally, the PFM study fails to present sufficiently detailed data, models and calculations needed to fully assess the validity of the results. Complete public access to PFM's models and data is needed.

Significant Flaws Found in Initial Review of Study

On October 25, 2011, the Corbett administration released *Liquor Privatization Analysis* (hereafter *LPA*), a study by Public Finance Management (PFM) evaluating the state revenue, tax, and consumer implications of a possible privatization of Pennsylvania's state wine and spirits distribution system.¹ While a full analysis of the 285-page PFM study will require many weeks, even a preliminary review reveals significant potential flaws. These flaws call into question (a) the PFM projections that the state would receive over \$1 billion up front and that privatization would still be revenue neutral for the Commonwealth over time (i.e., deliver the same annual funds to the Pennsylvania General Fund), and (b) PFM's claim that privatization would not increase alcohol-related traffic fatalities or other social problems associated with excessive consumption of alcohol.

Given more realistic assumptions and based on experience with privatization in West Virginia, auctioning off Pennsylvania's wine and spirits stores still appears to be a bad deal for the Commonwealth. Jeopardizing a reliable revenue source during these austere economic times could burden the Commonwealth's ability to fund other services in the years ahead. Moreover, this privatization venture will substantially increase the availability of wine and spirits and reduce the Commonwealth's ability to regulate liquor and wine consumption, potentially exacerbating social costs related to alcohol abuse.

¹ The PFM report is available online at

http://www.budget.state.pa.us/portal/server.pt/community/liquor_privatization_analysis_final_report/4575.

One general problem with the PFM study is that it does not start with the question “Is it in the best interest of Pennsylvania to privatize this service?” and then proceed with an assessment of the pros and cons of privatization on a range of issues (impact on state revenues, impact on consumers, social impacts, etc.). Instead, PFM appears to take its assignment as making the case for privatization in part by justifying prior claims of privatization proponents. One indication of the PFM study’s pro-privatization orientation is that it only evaluates privatization and does not compare privatization options against keeping the service public. In particular, several potential improvements to the public operations are mentioned in the study but never factored into the long-term cost and revenue projections for sustaining the service as a public operation.

The Study’s Flaws

- **PFM’s projection of the up-front revenue from selling liquor licenses appears substantially inflated** because it fails to factor in (i) real-world evidence from West Virginia, (ii) that companies won’t pay as much up front when future revenues and profits are uncertain, and (iii) that companies won’t pay as much up front when they have to pay annual license fees of over \$100 million. PFM describes (albeit not in sufficient detail) how it generated its estimates of the likely revenues from selling retail and wholesale liquor distribution licenses in a chapter titled “Valuation” (*LPA*, pp. 142-153). PFM described three methods of estimating what companies will pay for licenses, each of them a different way of getting at how much profit bidders expect once they acquire a license. All of these methods appear to have in common three flaws that lead to inflated projections of up-front fees:

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In one scenario, the annual fees to be paid directly by wholesale and retail licensees equal \$118 million, in the second, \$38 million (*LPA*, pp. 243-244). If licensees have to pay significant annual fees, they won’t pay as much up front. Yet ...this reality may not have been factored into the valuation analysis.

- *PFM fails to take account of the impact of uncertainty on franchise fees:* in any auction for a revenue-generating asset, uncertainty in the revenues and profits that will result lowers what companies will pay up front (because uncertainty creates the potential for “below-normal” profit levels, or even losses, if the asset under-performs). Yet PFM never discounts expected bids to take account of this uncertainty.
- *Second, and related, there is no mention in this chapter of other states’ experience,* including the fact that neighboring West Virginia received far less than expected from its auction of licenses. Clearly, an assessment of the disappointing auction fees in West Virginia is called for, including whether it stemmed from uncertainty or other facts in common between Pennsylvania and its neighbor to the south.
- *Third, in its estimate of up-front franchise fees, it is not clear whether PFM took account of annual fees required to achieve revenue neutrality.* Both of the privatization scenarios modeled by PFM “...assume new and enhanced fees and taxes will be imposed at the wholesale and retail level to achieve Fiscal Neutrality” (*LPA*, p. 241). In one scenario, the

annual fees to be paid directly by wholesale and retail licensees equal \$118 million, in the second, \$38 million (*LPA*, pp. 243-244). If licensees have to pay significant annual fees, they won't pay as much up front. Yet our initial review indicates that this reality may not have been factored into the valuation analysis. (Nor is there evidence that the impact of tax increases is adequately factored into projected sales and profits.)

The end of the *LPA* valuation chapter (p. 152) has a paragraph that suggests that PFM knows that its projections maybe optimistic. This paragraph is worth quoting at length so that readers of this brief can draw their own conclusions about what it means:

“The auction process is a complex and intricate endeavor. If the Commonwealth pursues an auction strategy for retail and/or wholesale license under any privatization option, it is vulnerable up-front revenue. The implementation of an auction strategy is something the Commonwealth would need to pursue in a deliberate and careful manner. A comprehensive and properly structured auction strategy should be part of the Commonwealth's approach to ensure the full maximization of up-front revenue.”

Could this be “consultant-speak” for when you get much less than \$1.1 billion, we will say it is because your auction wasn't “deliberate and careful” enough?

In sum, our initial review makes us skeptical of the projection that the Commonwealth could receive \$1.1 billion to \$1.6 billion up front for retail and wholesale licenses while achieving revenue neutrality in subsequent years.

- **PFM appears to conclude that privatization would be “revenue neutral” by relying on an unrealistically pessimistic projection for public revenues.** Specifically, the baseline financial estimates developed in the chapter titled “PLCB Financial Overview” are based primarily on FY 2009-10, which was the weakest year financially in the prior decade (all PFM estimates in this and the next bullet are from *LPA*, pp. 40-41). Forecasting from the atypical FY 2009-2010 figures leads PFM to make projections that are already substantially off in year one. PFM's projected net income for FY 2010-11 of \$67.3 million is 24% below the actual (unaudited) figure of \$83.7 million. Indeed, the actual revenue figure exceeds the PFM “high estimate” of \$74.1 million. PFM admits this difference in a note at the bottom of page 41, yet never adjusts its forecast for 2010-15 based on the available 2010-11 numbers. Given this inaccuracy, it is difficult to have confidence in PFM's projections several years forward.
- **PFM overstates public operational costs.** PFM's 2010-11 estimate for operating expenses was \$436 million (*LPA*, p. 41), versus the actual figure of \$406 million (\$386 operating plus \$20 million for Pennsylvania State Police (PSP) enforcement) as per the most recent financial statements for the Pennsylvania Liquor Control Board (PLCB). By low-balling the estimate for revenues in the public operation, and exaggerating estimates for public operational expenses, PFM purports to show that public operational cost increases will outpace revenue increases for as far as the eye can see. PFM uses the same flawed analysis to raise questions about the viability of the PLCB (*LPA*, p. 6).
- **PFM neglects to factor in cost savings or revenue-enhancing measures that can be implemented by the PLCB without privatization.** For example, the PFM report mentions, but

does not appear to factor in, the consolidation of the Scranton and Philadelphia distribution centers (both of which are already operated by private companies). This change—which is wholly separate from the overall retail and wholesale privatization decision and could be done within the public system—is estimated to reduce operating costs by \$51 million over 10 years (*LPA*, p. 32). Other proposed changes, such as removing Sunday sales restrictions and hours (*LPA*, pp. 20-21), are never factored into the public operation, yet are critical assumptions in the financial estimates of the privatized model. The main point here is that the Commonwealth can evaluate and implement these policy changes without privatization. By assuming these changes will occur only under a privatized model, PFM creates a false comparison with the current public operation.

- **Arriving at revenue neutrality also requires PFM to present an optimistic estimate for the revenues of a privatized system.** For example, PFM assumes an increase of \$92 million in sales from a privatized system, and that most of this increase will result from repatriated sales in border locations (*LPA*, p. 124). At the same time, PFM recommends moving from a tax based on value (i.e., that is a percentage of the sales price) to a gallonage (or “per gallon”) tax. (With a value-based tax, a 1.5 liter bottle costing \$7.50 incurs half as much tax as a 750 ml bottle costing \$15; with a per gallon tax, the same 1.5 liter bottle incurs a tax twice as large as the 750 ml bottle.) PFM points out that maintaining state revenues with a gallonage tax would give Pennsylvania the highest wine taxes in the nation. With a gallonage tax, Pennsylvania prices would be particularly non-competitive in border areas, especially for lower-cost products. It is not clear that PFM’s assumptions about repatriated sales in border areas are compatible with the gallonage tax rate needed to achieve revenue neutrality.
- **PFM also makes optimistic assumptions about tax collections.** In another optimistic assumption required to reach revenue neutrality, PFM ignores the potential for a drop off in tax collections as a result of the combination of privatization and the switch to a gallonage tax. (PFM does acknowledge on *LPA*, p. 82, that “A collection loss on sales tax, either through under-reporting or incorrect submissions, could result in a loss of revenues.”) With either lower sales than PFM assumes, or lower tax collections, privatization will be a revenue loser.
- **The PFM plan may bring lower availability and higher prices for rural consumers.** In West Virginia, there were no bids for some rural areas. The lack of private-sector interest in rural markets in Pennsylvania could also mean reduced selection in rural stores that do exist. In addition, the tax rates needed to approach revenue neutrality in Pennsylvania, and the switch to taxation based on volume rather than value, will mean that rural areas which do have wine and spirits licensees will face very high prices.

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The potential for an increase in alcohol-related social problems is why a rigorous national Task Force of public health professionals appointed by the Centers for Disease Control and Prevention recommended in April against further privatization of alcohol distribution in U.S. states.

- **Alcohol-related social problems could increase with privatization.** PFM recommends a large increase in the number of retail outlets in the state. This is likely to increase alcohol-related social problems, including traffic fatalities. The potential for an increase in alcohol-related social problems is why a rigorous national Task Force of public health professionals appointed by the Centers for Disease Control and Prevention recommended in April against further privatization of alcohol distribution in U.S. states.² PFM obfuscates this issue by discussing an earlier analysis by the same Task Force which did not recommend against (or for) privatization, but failing to state clearly that the more recent Task Force opinion supersedes the earlier one. (The most recent study evaluated additional research and probed the impacts of privatization on excessive consumption of alcohol more deeply.) PFM also clouds the discussion of social impacts with a lengthy discussion of research literature that ignores the fact that the most recent Task Force report used a rigorous methodology to select the “best” research studies and rendered its recommendation against privatization based on those studies.
- **Privatization could eliminate thousands of middle-class jobs.** The PFM study estimates 3,200 jobs would be lost within the state's wine and spirits retail stores. While PFM also points to opportunities for job gains in private retailers, it does not analyze the quality of those jobs, thereby avoiding the need to document the obvious: most new private retail jobs for hourly workers are unlikely to pay wages and benefits sufficient to support a family.
- **The PFM study does not present sufficiently detailed data, models, and calculations to allow for real scrutiny.** Despite its length, the PFM study is not transparent. The models it used to generate different estimates are described in general terms, but the fully specified models are not presented; the data used to justify different assumptions are also described in general terms. Nothing short of complete public access to PFM’s models and data will be adequate for lawmakers and Pennsylvania citizens to comprehensively assess the validity of the results.

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Conclusion

All these concerns underscore the need for due diligence in analyzing PFM’s assumptions. It is prudent to understand much more thoroughly what has happened in other states that privatized wine and liquor

² For more on this, see Stephen Herzenberg, *National Public Health Task Force Recommends Against Privatization of Retail Alcohol Sales*, Keystone Research Center Policy Brief, online at <http://kestoneresearch.org/publications/research/national-public-health-task-force-recommends-against-privatization-retail-alco>

sales and distribution, particularly when it comes to the revenue impact. Pennsylvania should look at the experiences of West Virginia and Iowa before taking a similar leap. It is notable that the PFM study—in addition to failing to mention that auction of licenses in West Virginia raised less than expected—does not acknowledge that annual revenues declined in Iowa following privatization.

Given the length and complexity of the PFM study, and the need for a protocol to be established for independent researchers to access all of PFM's models and data, it will take legislators and the public the rest of this calendar year and beyond to assess this study. In making decisions about the future of Pennsylvania's wine and spirits stores, lawmakers cannot simply "trust the experts" at PFM. Doing that risks giving away the store.

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