

# Iowa Legislative Fiscal Bureau

Dennis Prouty  
(515) 281-5279  
FAX 281-8451



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## State Liquor Wholesaling

### ISSUE

This *Issue Review* examines the State of Iowa's involvement with liquor wholesales and provides alternatives.

### AFFECTED AGENCIES

Department of Commerce, Division of Alcoholic Beverages

### CODE AUTHORITY

Chapter 123, Code of Iowa

### BACKGROUND

Iowa's involvement in liquor sales began in 1934 as a complete monopolistic system of the wholesale and retail sale of wine and spirits through state-operated liquor stores. Today, the State wholesales and distributes spirits only to privately owned retail stores through the Iowa Alcoholic Beverages Division (Division). The Division uses a private sector warehousing contractor to receive, store, and deliver spirits on behalf of the State.

The State retains the profit that would otherwise go to private sector wholesalers by being directly involved in the sale and distribution of spirits. All states collect tax from the sale of spirits, with the main difference being the methods used by each state to collect liquor revenue.

Eighteen states, including Iowa and one county in Maryland are directly involved in the sale of spirits and are referred to as the Control States. The control jurisdictions formed at the end of Prohibition, and none of the original 19 jurisdictions has abandoned the Control State System.

The other 32 states are referred to as License States and alcoholic beverage products are trafficked by privately-owned wholesalers. The License States, through their respective Alcohol Beverage Commissions, usually apply a flat tax on each gallon sold by a wholesaler to a retailer. Additionally the private sector wholesaler imposes a mark-up (profit).

In Control States, all profit made from the mark-up on liquor sales to retailers are turned over to state treasuries.

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The following table depicts the flow of spirit products and tax collections in a Control State versus a License State environment:

	Tier 1	Tier 2	Tier 3	Tier 4
CONTROL	Liquor Supplier	State Wholesaler (tax mark-up)	Licensed Retailer	
LICENSE	Liquor Supplier	Tax Paid to State Liquor Board	Private Wholesaler (profit mark-up)	Licensed Retailer

### **CURRENT SITUATION**

Iowa wholesales spirits to over 460 privately owned liquor outlets that sell liquor to consumers as well as bars, restaurants, and other on-premises locations at a 50.0% mark-up (tax) over the Division's cost. Iowa's 50.0% mark-up over the Division's costs on wholesale sales generates over \$39.2 million net revenue annually. The Division will deliver an order as small as five cases, while some large volume retailers receive deliveries twice weekly.

Section 123.24, Code of Iowa, requires the Division to offer the same price on spirits to all retailers regardless of the quantity purchased. It also offers the same terms on delivery to all retailers regardless of their location in Iowa. These practices enable over 200 small independently-owned stores to co-exist and compete with large volume chain stores.

### **FY 2003 Estimated Gross Revenue Derived from State Liquor Wholesaling**

The following table shows the estimated gross liquor wholesaling revenue that Iowa will receive in FY 2003. Since suppliers increase their product price to the State each year, the State can make increased profits even when gallon sales stay constant or even slightly decrease. This would not be the case if a flat per gallon tax was used. The dollar amount sold increased by 3.4%, while the gallons sold were up by 1.2% in FY 2002. If Iowa applied only a flat per gallon tax, collections would have increased by only 1.2%.

FY 2003 Estimated Gross Liquor Revenue	
Gross Liquor Sales	\$ 117,559,683
Cost of Goods Sold	77,138,900
<b>Gross Wholesale Profit</b>	<b>\$ 40,420,783</b>
Other Wholesale Revenues	
Bailment Fee	\$ 755,418
Split Case Fee	400,683
Miscellaneous Income	61,000
Bottle Deposit Fee	556,865
Bottle Recycle Surcharge	222,746
<b>Total Gross Wholesale Profit</b>	<b>\$ 42,417,495</b>

Liquor wholesaling activity is one of four core functions performed by the Division. The other core functions include:

- The licensing of all businesses that manufacture, import, wholesale or retail alcoholic beverage products in Iowa.
- Regulation of the business/financial transactions conducted between the various tiers of the alcoholic beverages industry in Iowa. Included are the collection and auditing of beer and wine excise taxes and regulating federal and State statutes that define the legal transactions allowed between a supplier/wholesaler and retailer.
- Enforcement of Iowa's tobacco laws by conducting compliance checks of tobacco retailers and providing for youth tobacco sales prevention education for retailers, law enforcement, and local officials. Funding for the Division's tobacco enforcement program comes entirely from the State tobacco settlement.

### **ALTERNATIVES**

Iowa could leave the liquor business at an increased cost to regulate the business transactions and collect taxes from private sector wholesalers. Iowa could tax sales made by new wholesalers to create a revenue neutral situation to the State General Fund at the cost of higher liquor prices to the Iowa consumer, as explained in the Budget Impact Section below. If Iowa were not directly involved in the wholesaling of spirits, the Division would have to regulate the business transactions between private sector wholesalers and retailers to ensure the accurate collection of a State-mandated gallonage tax.

The Division indicates there are currently three brokerage firms that are positioned to initially take over the wholesaling of spirits to Iowa retailers. The three brokerage firms already have ties with liquor distillers in the respect that the firms represent the distillers' products in Iowa and are paid a fee for each case of liquor sold. Two of the three are already in the warehousing/distribution business operating as wine wholesalers. All three have corporate headquarters outside of Iowa. Some initial investment would be required for these entities to take over the wholesaling market.

The Division stated that the Iowa market is not large enough to satisfy three liquor wholesalers. California, with over 35.0 million people, supports two large wholesalers. Michigan, which sells almost five times the amount of liquor as Iowa, has two large and one smaller volume wholesaler. It is estimated that within a short period of time Iowa would be left with two liquor wholesalers. Additionally, these two remaining wholesalers would have ties to specific major suppliers and would not carry the same brands. Consequently, there would be no price competition, and instead there would be brand competition from which retailers could choose.

### **BUDGET IMPACT**

#### **Sale of the Facility**

The facility is located at 1918 SE Hulsizer Rd, Ankeny, and consists of a 175,000 square foot building divided into a 150,000 square foot warehouse and a 25,000 square foot office area. The building sits on approximately 11 acres of land with seven acres dedicated to the facility, truck parking (warehouse area) and office/visitor parking. There are four landlocked acres behind the facility.

The original land purchase and building construction cost was financed by the sale of \$4.4 million in special liquor revenue bonds. The facility was completed in 1980. The Polk County Assessor's

Office has estimated the building has a value of \$6.1 million. The estimated property tax would be \$226,000 if the owner of the property paid taxes.

In addition to the Division's operation and employees, the facility is also occupied by the following:

- The Professional Licensing Division of Commerce, approximately 6,500 square feet office space.
- The Iowa Lottery Warehouse Operation, approximately 12,500 square feet warehouse space.
- The Iowa Department of Public Safety, approximately 600 square feet warehouse space.

In addition to the current operations housed in the facility, there are plans to locate the State's archival records and documents currently stored under the management of the Departments of Revenue & Finance and Cultural Affairs. The Division is planning to make approximately 15,000-20,000 square feet available for record storage and other uses as determined by General Services.

There is also approximately 6,000 square feet of office space that was recently vacated by the decentralization of the Administrative Services Division of Commerce (July 2002). The Department of General Services is currently assessing this space for use by other State agencies.

### **Sale of Inventory**

The Division operates under a bailment inventory system in that the distiller/supplier maintains ownership of the inventory until the Division sells the product. Consequently, the State has virtually no investment in the liquor inventory.

### **Division Operations**

Under current operations, 7.0 of the 33.0 FTE positions in the Division are completely dedicated to liquor wholesaling activities. The warehousing and delivery functions are performed entirely by a private sector contractor. The remaining 26.0 FTE positions are dedicated to licensing activities, tobacco enforcement, accounting, information technology, building maintenance, and administration.

The Division has 8.0 FTE positions dedicated to tobacco enforcement and education initiatives. The Tobacco Enforcement Section of the Division is eliminated from the pro rata expense equation since the employees and support costs in the Section are funded and expensed separately from other Division operations. Of the remaining 25.0 FTE positions, the Division has determined that 7.0 FTE positions could be eliminated under a private liquor wholesaling system; including the 5.0 FTE positions in the Products Section and 2.0 FTE positions in the Information Technology Section. This represents a 28.0% reduction in the Division staff. Additionally, the 28.0% reduction could be applied to the following areas: office supplies, outside services and workers compensation costs. A 50.0% reduction would be applied to in-state travel expense. Some future minor expense savings might also be realized in the areas of printing costs and reimbursements.

### **Budget Comparison Under a Private Wholesale System**

Although the Division applies a straight 50.0% mark-up (tax) to the cost of goods sold, when all other fees and revenue generated by the wholesaling system (bailment fee, split-case fee, etc.) are factored, the equivalent profit mark-up is 55.0%. The \$3.2 million expense reduction expected under a private wholesaling system would still require the equivalent of a 50.8% mark-up (tax) for the State to break even with current revenue production. The following table shows estimated budgets under the current structure and a Private Wholesale System.

FY 2003 DIVISION BUDGET (with State as Wholesaler)			FY 2003 DIVISION BUDGET (Private Wholesale System)	
		FTEs		FTEs
Commission	\$ 6,000	0.0	\$ 6,000	0.0
Administration	572,597	5.0	545,317	5.0
Accounting	320,652	5.0	320,652	5.0
Maintenance	72,810	1.0	72,810	1.0
Information Technology	278,159	3.0	123,965	1.0
Licensing	284,945	6.0	284,945	6.0
Products	242,764	5.0	0	0.0
Building & Grounds	85,000	0.0	85,000	0.0
Tobacco Enforcement	1,000,000	8.0	1,000,000	8.0
Routine Maintenance	10,000	0.0	10,000	0.0
<b>Subtotal</b>	<b>\$ 2,872,927</b>	<b>33.0</b>	<b>\$ 2,448,689</b>	<b>26.0</b>
<b>Other Expenditures:</b>				
Warehousing/Delivery	\$ 2,036,392			
Bottle Deposit Refunds	326,949			
Bottle Recycle Expense	441,381			
Miscellaneous Expense	7,732			
<b>Grand Total Expense</b>	<b>\$ 5,685,381</b>	<b>33.0</b>	<b>\$ 2,448,689</b>	<b>26.0</b>
Reduction Under Private Wholesaling:			\$ 3,236,692	7.0

**Tax Needed to Achieve Revenue Neutrality**

Plans in the past to privatize wholesale liquor sales in Iowa have called for a flat per gallon tax to replace State revenue. Usually, the plans have called for a dollar amount based on 80 or 100 proof rates per gallon (industry standards). Based on current net revenue of \$39.2 million, and the average sale of 70 proof per gallon, a \$13.31 per 70 proof gallon tax would be necessary to achieve revenue neutrality. However, any plan that called for an 80 or 100 proof tax rate would require a higher dollar rate to achieve neutrality since it takes more sales of 70 proof alcohol to equal an 80 or 100 proof gallon.

FY 2003 Gross Income		
Under State Wholesale System		\$ 42,417,495
Reduction in FY 2003 Division Expense Due to Wholesale Privatization		\$ 3,236,692
Tax Needed to Replace State Wholesale Liquor Revenue		\$ 39,180,803
Tax Needed per Gallon to Break Even (2,943,446 Estimated FY 2003 gallons sold @ current 70 proof avg.)		\$ 13.31 per 70 proof gal.
	OR	\$ 15.21 per 80 proof gal.
	OR	\$ 19.02 per 100 proof gal.

The following table is a comparison of the tax rates of states contiguous to Iowa.

2001 TAX RATE BASED ON 80 PROOF GALLON (Source: Adams 2002 liquor handbook)			
Illinois*	\$4.50	South Dakota*	\$3.93
Missouri	\$2.00	Minnesota**	\$5.03
Nebraska	\$3.00	Wisconsin	\$3.25

\*Different rates also applicable according to alcohol content, place of production, size of container, and place purchased (on or off-premises or on board airlines).

\*\*Includes case fees and/or bottle fees, which may vary with the size of container.

**Effect on the Consumer Bottle Price under a Revenue Neutral and a Price Neutral Private Wholesale System**

For Iowa to maintain current net liquor revenue, consumer prices under a private wholesale system would increase because of the addition of another profit layer – the wholesaler’s mark-up. Private sector wholesalers in License States attempt to average a 16.0-20.0% wholesale mark-up on sales made to retailers. The example below uses an average wholesale mark-up of 18.0%. The following example shows how the current average consumer bottle price would increase by 18.5% due to the added profit layer:

- Estimated FY 2003 Average Cost per Bottle \$6.92  
(\$77,138,900 cost of goods / 11,144,663 FY03 est. bottle sales)
- Estimated FY 2003 Average Size Bottle Sold 33.8 oz. (or 26.4% of a gal.)  
(2,943,446 gallons / 11,144,663 bottle sales)
- Tax per bottle necessary to achieve revenue neutrality\* \$3.51 (26.4% of \$13.31 gal. tax)

The following example is based on a flat tax per gallon sold. A tax on sales of 80 or 100 proof gallons would require an even higher tax rate to achieve revenue neutrality.

	Current State Pricing	Private Wholesaling Pricing	
Avg. Cost per Bottle	\$ 6.92	\$ 6.92	
State 50.0% Mark-up	3.46		
State Gallon Tax Under Privatization (Per Avg. Bottle)		3.51	
Private Wholesaler Avg. Mark-up 18.0%		1.88	
Cost to Retailer	10.38	12.31	
Average Retailer Mark-up (20.0%)	2.08	2.46	
Consumer Price	12.46	14.77	
<b>Price Increase to Consumer</b>	\$ 0.00	\$ 2.31	18.5%

If the State privatized wholesale liquor sales using a gallon tax based on 80 or 100 proof gallons, the estimated tax rates for the average bottle size sold would be \$4.02 and \$5.02, respectively. At those rates, the price of an average bottle would increase 24.0% to the consumer at the 80 proof rate and would increase 36.0% at the 100 proof rate.

**Summary**

If Iowa decided to privatize wholesale liquor sales without raising the average bottle price to the consumer, a tax rate of \$7.12 per gallon sold would be required and estimated revenue generated would be \$20.9 million, resulting in a loss in revenue of \$18.2 million. These estimates are based upon the following:

- The estimated FY 2003 Average Cost per Bottle is \$6.92.  
(\$77,138,900 cost of goods divided by 11,144,663 FY 2003 est. bottle sales)
- The estimated FY 2003 Average Size of a Bottle Sold is 33.8 oz. (26.4% of a gallon).  
(2,943,446 gallons divided by 11,144.663 bottle sales)
- The tax per bottle necessary to maintain the current consumer price is \$1.88. (26.4% of \$7.12 gal. tax)

	Current State Pricing	Private Wholesaling Pricing	
Avg. Cost Per Bottle	\$ 6.92	\$ 6.92	
State 50.0% Mark-up	3.46		
State Gallon Tax Under Privatization (Per Avg. Bottle)		1.88	
Private Wholesaler Avg. Mark-up 18.0%		1.58	
Cost to Retailer	10.38	10.38	
Average Retailer Mark-up (20.0%)	2.08	2.08	
Consumer Price	12.46	12.46	
<b>Price Increase to Consumer</b>	\$ 0.00	\$ 0.00	0.0%

Revenue Under Private Wholesale Price Neutral System (FY 2003 gallons 2,943,446 x \$7.12 per gallon)	\$20,957,336
FY 2003 Loss Under Price Neutral System	\$18,223,467
<b>Current Net Liquor Revenue</b>	<b>\$39,180,803</b>

STAFF CONTACT: Ron Robinson (Ext. 16256)

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<http://staffweb.legis.state.ia.us/lfb/IREVIEW/ireview.htm>  
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