AN ANALYSIS OF THE PRIVATIZATION OF THE MERCHANDISING AND WAREHOUSING DIVISIONS OF THE MICHIGAN LIQUOR CONTROL COMMISSION

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In December 1996, the Michigan Legislature amended the Liquor Control Code to allow the Michigan Liquor Control Commission to contract out the warehousing and distribution of spirits to the private sector. This change allows private distribution companies, referred to as authorized distribution agents (ADAs), to enter into contracts with the suppliers of spirits to provide the warehousing and distribution services that had previously been provided by the State. This article presents an estimate of the impact on State government from switching to a privatized distribution system.

State-Run System

Michigan is one of 18 control states, meaning the State is responsible for the purchasing, warehousing, and distribution of spirits, in addition to the licensing of manufacturers of all beer, wine, distilled spirits, and mixed spirits. Prior to privatization, the distribution of liquor began with the suppliers or manufacturers of liquor who shipped their products to one of the two State-owned warehouses in Lincoln Park and Lansing. The State assessed a bailment fee of 83 cents per case on the supplier for warehousing the product. This fee revenue covered most of the operating costs of the warehouses, including the salaries and wages of the State employees running these facilities.

The liquor was then transported from the State-owned warehouses to a third warehouse in Escanaba and 63 regional State stores by private trucking companies. The State leased 62 of the regional stores and the Escanaba warehouse from private owners, but owned one regional State store as it was located on the same site as the Lincoln Park warehouse.

These warehouses and stores were staffed with approximately 400 State employees. The Commission added a 25-cent per case fee onto the retail price to cover the cost of distributing liquor from the warehouses to the stores. These regional stores prepared liquor orders taken from the licensees, who were then personally and financially responsible for transporting the liquor from the State liquor store to the retail establishments.

The Liquor Purchase Revolving Fund is maintained by the Commission and is used to fund the administration of the Commission as well as purchasing, warehousing, and distribution of liquor throughout the State. All revenues from the sale of liquor are deposited into this Fund and any balance at year end, after all expenses are paid, is transferred to the General Fund in accordance with the Management and Budget Act, Public Act 431 of 1984, MCL 18.1101 to 18.1594.

Privatized System

With privatization the State closed all three warehouses, terminated the leases on the Escanaba warehouse and the 62 regional stores, and laid off all of the State employees working out of these locations. The private distribution companies (ADAs) were required to set up contractual agreements with suppliers to warehouse and distribute the liquor to all licensees. The Commission still orders and purchases all the liquor sold in this State from the suppliers, but the suppliers ship the product directly to the ADAs' facilities.

There are seven ADAs that have been certified by the Commission to distribute spirits throughout the State. The ADAs must provide statewide distribution service for each product on at least a weekly basis. All licensees receive free delivery of the product to their retail establishment, unless it is an emergency order. Retailers are required to order at least one case of liquor from an ADA to be eligible for free delivery; the case can include a split or mixed case of liquor. All liquor orders are placed by the retailers with the ADAs who then transmit the orders to the Commission for the purchase to be made. A per-case fee of $5.42 for the cost of warehousing and delivery is paid to the suppliers by the Commission for each case purchased by a licensee, as allowed under the amended Code.

As with the State-run system, all revenues are deposited into the Revolving Fund and any balance in the Fund at year end is deposited into the General Fund.

State-Run vs. Privatized

To estimate the fiscal implications of this change to a privatized distribution system, an analysis has been done using data for fiscal year (FY) 1995-96, the last full fiscal year under the State- run system, and FY 1997-98, the first full fiscal year under the privatized system. For each of these years, an estimate was made of what revenues and expenditures would have been under the alternative distribution system (the privatized system in FY 1995-96 and the State-run system in FY 1997-98). These estimates were then compared with actual revenues and expenditures, as reported by the Liquor Control Commission in the respective annual report from each of those years. The analysis for FY1995-96 is presented in Table 1 and the analysis for FY1997-98 is presented in Table 2. For each of these years, it is estimated that the State-run distribution system would have resulted in a higher profit (meaning a larger balance would have been transferred to the General Fund), compared with the private distribution system, but the difference narrows from $3.7 million in FY 1995-96 to $1.6 million in FY 1997-98. This narrowing gap could be the result of a number of factors including increased revenue due to changes in liquor sales as well as possible long-term reduced cost due to privatization.

Sales. As Tables 1 and 2 show, the gross revenue from the sale of liquor has increased by 2.1% from FY 1995-96 to FY 1997-98. According to the Liquor Control Commission's FY 1997-98 Annual Report, case sales have increased by 2.1% and prices for liquor have seen increases from all suppliers for each year. Additionally, sales of higher-priced liquor or premium brands along with sales of lower-priced items have increased, while sales of medium-priced items have remained stable or decreased. Assumptions could be made regarding the current state of the economy and its impact on consumers of distilled spirits who may be more inclined to "buy up" from a usual middle-priced brand. In addition, the Commission has suggested that the increased revenue also may be the result of the increase in the number of brands that are available, as the ADAs now carry more than 3,875 items in inventory compared with the 950 items in inventory and 1,100 special order items available to retailers under the State-run system.

Table 1: FY 1995-96 LIQUOR PURCHASE REVOLVING FUND REVENUES AND EXPENDITURES

	(a) State-Run System FY 1995-96	(b) Estimated Privatized System FY 1995-96	Dollar Change (b)-(a)
Revenues			
Gross Revenue from Sale of Liquor	$129,781,064	$129,781,064	$ 0
Bailment Fee	4,220,687	0	(4,220,687)
Miscellaneous Revenue and Taxes	8,415,715	8,415,715	0
Total Revenue	**$142,417,466**	**$138,196,779**	**$(4,220,687)**
Expenditures			
Salaries and Wages	28,847,765	5,897,956	(22,949,809)
Freight Cost/Per-Case Fee Paid to ADAs	1,697,210	26,860,322	25,163,112
Transfers To Other Agencies	10,111,508	8,101,058	(2,010,450)
Unappropriated Expenses	785,925	58,068	(727,857)
Fire Protection Grants	6,375,000	6,375,000	0
Total Expenditures	**$47,817,408**	**$47,292,404**	**$(525,004)**
Revenue into the General Fund	**$94,600,058**	**$90,904,375**	**$(3,695,683)**

(a) Actual numbers from the FY 1995-96 Michigan Liquor Control Commission Annual Report.
(b) Estimated numbers based on actual FY 1995-96 Case and Gross Sales numbers.

Because there is no way to factor out how much of the increase in revenue is attributable to the economy, how much is attributable to the increased selection, or how much is attributable to a price increase, the FY 1997-98 estimated State-run system numbers assume the privatized gross sales revenue amount. It should be noted, however, that this estimate may be slightly inflated as the State would not have carried as many brands as are now available, which may include a number of premium brands, and would therefore account for additional sales revenue.

Table 2: FY 1997-98 LIQUOR PURCHASE REVOLVING FUND REVENUES AND EXPENDITURES

	(a) Estimated State-Run System FY 1997-98	(b) Privatized System FY 1997-98	Dollar Change (b)-(a)
Revenues			
Gross Revenue from Sale of Liquor	$132,443,076	$132,443,076	$ 0
Bailment Fee	4,199,744	0	(4,199,744)
Miscellaneous Revenue and Taxes	11,519,165	11,519,165	0
Total Revenue	**$148,161,985**	**$143,962,241**	**$(4,199,744)**
Expenditures			
Salaries and Wages	31,430,446	7,082,994	(24,347,452)
Freight Cost/Per-Case Fee Paid to ADAs	1,800,000	26,701,460	24,901,460
Transfers To Other Agencies	10,129,025	7,719,927	(2,409,098)
Unappropriated Expenses	(45,855)	(773,712)	(727,857)
Fire Protection Grants	6,535,000	6,535,000	0
Total Expenditures	**$49,848,616**	**$47,265,669**	**$(2,582,947)**
Revenue into the General Fund	**$98,313,369**	**$96,696,572**	**$(1,616,797)**

(a) Estimated numbers based on actual FY 1997-98 Case and Gross Sales numbers.
(b) Actual numbers from the FY 1997-98 Michigan Liquor Control Commission Annual Report.

Costs. Also listed in the tables are the differing levels of costs for the State-run system versus the privatized system. The assumptions for the State-run system include an annual 3% cost- of-living increase for salaries and fringe benefit expenses. This amount would have continued to increase regardless of the level of the case sales. Under the privatized system, costs are directly tied to the number of case sales as the ADAs are compensated through a per-case fee. The current law allows for the fee to be set at a minimum of $4.50 and a maximum of $7.50 per case. If there is no increase in the per-case fee, and the gross sales revenues continue at the FY 1997-98 level or higher, then eventually the State-run system would have become more costly than the existing privatized system. If the per-case fee is increased above the current level of $5.42, and gross sales remain constant, then the State's profit might be equal to or less than what would have been afforded under the State-run system, depending on the level of the fee increase.

Conclusion. Although a major impetus for this change was to reduce the cost of administering the liquor distribution system, while maintaining or increasing the profit generated from the sale of liquor, it appears that in the first year of privatization that may not have been the case. There may, however, be long-term savings to the State as future health and retirement benefits associated with State employees have been eliminated. This analysis does provide preliminary evidence that the gap in the profits generated has diminished from FY 1995-96 to FY 1997-98. If this is a trend that continues, it may result in savings to the State as the cost of the privatized system is tied to case sales whereas the cost of the State-run system would have continued to increase regardless of case sales. Finally, this analysis does not include the savings that may be realized by retail licensees under the privatized system. As the new system has transferred the delivery responsibilities from the licensees to the ADAs, this change has resulted in direct savings to the licensees (estimated to be $6 million annually by Management Analysis, Inc.), as licensees are no longer liable for staff and transportation costs, which were included under the State-run system.