Should the Commonwealth of Virginia Privatize Liquor Sales?

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ABSTRACT

Privatization is an effective policy choice for governments to reduce public debt, improve the financial health of the private sector, and improve the firm's economic efficiency. However, beyond the economic and financial factors, there are several political implications of privatization policies that are important to consider. Although many economic benefits are presumed to occur due to privatization, the unique position of the Virginia Alcoholic Beverage Control Authority (VA ABC) makes it, unlike most public firms that have been considered for privatization. Privatizing this firm would result in the Commonwealth of Virginia losing over $250 million from its General Fund annually and would negatively impact the state's labor market. This policy brief examines the economic, financial, and political motivations to privatize state-owned enterprises and discusses the implications that privatizing the VA ABC would have on the Commonwealth.

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INTRODUCTION

The Commonwealth of Virginia is one of 17 states in which the distribution and sale of distilled spirits, i.e., liquor, are controlled by the state government (Virginia ABC n.d.). The Virginia Alcoholic Beverage Control Authority (VA ABC) is the agency that manages the retail sale and wholesale distribution of liquor as well as enforces and regulates the Commonwealth's alcohol laws (Commonwealth of Virginia n.d.). In 2022, the Virginia General Assembly introduced House Bill 328, which seeks to privatize government-owned liquor stores. If this bill passes, private firms that currently only sell beer and wine, e.g., grocery stores, gas stations, corner markets, etc., could sell liquor through government issuance of liquor licenses.

Additionally, this bill would require the VA ABC to dispose of all its real estate property and terminate all its leasing contracts. This policy brief examines potential economic impacts that privatizing the VA ABC would have on the Commonwealth's economy.

The VA ABC is a state-owned enterprise (SOE), which is a public organization that conducts business and commercial activities but is government owned. While there are other types of privatized government entities, such as public services and assets, the VA ABC is considered an SOE, so the bulk of the research included in this brief focuses primarily on the privatization of SOEs. Although privatization has several definitions depending on the context in which it is being used, the definition regarding "material privatization" is best for the purposes of this brief. Material privatization is thus defined as the process of transferring shares of SOEs from the public sector, either national or local governments, to the private sector (Megginson and Netter 2001, 321; Smith, Nightingale, and Pindus 1997; Yarrow 1986, 325). This transfer occurs when the shares of SOEs are sold off and the property rights and ownership are bought by private investors (Cuadrado-Ballesteros and Peña-Miguel 2019, 287; Obinger, Schmitt, and Taub 2016, 3).

The rest of this brief is structured as follows. First, a cursory review of the prior literature and empirical studies on privatization begins with a discussion on the history of privatization in the United States and the theories that have supported its use as a policy tool. Then, this brief examines the economic and political motivations that tend to drive privatization, including how governments privatize public firms as well as the techniques and outcomes of privatization policies. This brief then examines the current fiscal state of the VA ABC and discusses the potential effects of privatization. The last sections of this brief provide concluding remarks and policy recommendations.

PRIVITIZATION

In the United States, privatization has gained popularity at the federal level as a means to increase the private sector's participation in varying parts of the public sector (Henig 1989, 649). Support for privatization grew in the 1970s during a wave of deregulation policies that sought to limit the government's influence in the private sector and strengthen public-private partnerships (Henig 1989, 660-661). At the local level, privatization techniques were used as early as the 1970s in response to increasing fiscal constraints (Henig 1989, 658-659). By the 1990s, calls for privatization began to expand into social welfare programs and other social services and, with the increase of globalization in the market, are still deployed by politicians today (Boubakri et al. 2013; Smith, Nightingale, and Pindus 1997). The next section discusses the motivations for governments to privatize SOEs.

MOTIVATIONS TO PRIVITIZE

Governments seek to privatize for a variety of economic, financial, and political reasons (Gonzalo, Pina, and Torres 2003, 180). Several theoretical arguments offered within both the literature and empirical studies support reducing the public sector through privatization policies and are based on economic theory. Sheshinski and López-Calva (2003) examined empirical studies measuring the microeconomic and macroeconomic effects of privatization and found that in competitive markets, privatized SOEs improved their profitability and productivity. Through a microeconomic lens, SOEs present a "public monopoly" that lacks market competition or the economic and financial incentives to improve the firm's performance, which leads them to be inefficient and unresponsive to market demand (Henig 1989, 653). Additionally, SOEs can develop performance inefficiencies due to public ownership and management (Vickers and Yarrow 1991). SOEs have varying objectives that often do not include optimizing efficiency or maximizing profits as top priorities, but rather focus on the concerns of politicians (Boycko, Schleifer, and Vishny 1996). Public managers running SOEs also do not have to worry about the firm going bankrupt, shareholder oversight, or corporate takeovers undertaken due to poor financial performance; this view is referred to as the "managerial perspective" (Bel and Fageda 2007, 519-521; Sheshinski and López-Calva 2003; Yarrow 1986, 330-334). In addition, the performance of public firms is not thought to be monitored in the same way that private firms are by their shareholders. These factors combined with the lack of competition can result in a firm's underperformance (Sheshinski and López-Calva 2003). In short, the managerial perspective asserts that managers in public firms lack the incentives and financial oversight that push private firms to become more efficient.

By contrast, in the private sector, there is market competition between firms that incentivizes management to prioritize the firm's economic and financial performance. Typically, this is seen in performance measures that aim to optimize efficiency and maximize profits (Bel and Fageda 2007, 519-521; Yarrow 1986, 332-334). Privatization is frequently proposed to increase the economic efficiency of a firm and strengthen the overall well-being of the private sector (Henig 1989, 656-658; Sheshinski and López-Calva 2003). Another reason that privatization is proposed is because it is believed to improve a firm's overall efficiency due to market competition (Sheshinski and López-Calva 2003). In other words, due to competition in the market, managers of private firms are believed to have more incentive to lower costs and increase revenue for the firm than managers at firms in the public sector, thus improving the firm's performance.

Beyond the effects that privatization has on individual firms in domestic markets, other research has examined its effects on the global economy. Boubakri et al. (2013) looked at the relationship between privatization and globalization in 55 developing countries. In economics, globalization refers to how the entire world is becoming more interdependent through the expansion of technology and trade, and how this interdependence is progressively merging single domestic markets into one world market (Williamson 1998). Boubakri et al. (2013) specifically examined how privatization is associated with foreign direct investments and foreign portfolio investments, which are used to measure how connected a country is to the global market, in the BRICS countries of Brazil, Russia, India, and China (1899-1900). The study found that there is a positive association between globalization and privatization when the level of globalization in the developing country increased due to the privatization of SOEs. This positive relationship is thought to occur due to private foreign investors' interest in the developing country's economic market, which can lead to gross domestic product (GDP) growth (1912-1913). Interestingly, Son and Zohlnhöfer (2019) examined the magnitude of privatization effects by measuring five of the most widely used indicators of privatization: the Organisation for Economic Co-operation and Development (OECD) indicator of regulation in energy, transport, and communication; the indicator of public ownership; proceeds data from the OECD database; the Privatization Barometer (PB) index, which provides proceeds data on privatization activities in Europe; and data from the Retreat of the State from Entrepreneurial Activities (REST) database, which collects turnover information on different types of privatization as well as cases involving nationalization (404-410). The study found that there is a high correlation between privatization and both the PB index and the proceeds data from the OECD database but not with the other indicators (416-417). In other words, there seems to be a positive association between privatization and globalization in developing countries but in developed countries the relationship is not as strong. Measuring the relationship between globalization and privatization is clearly not as straightforward as it would seem.

Additionally, privatization has often been a policy tool used by both developed and developing countries to decrease government spending and reduce their fiscal debt (Bortolotti, Fantini, and Siniscalco 2003, 309; Gonzalo, Pina, and Torres 2003, 182). A major catalyst of privatization seems to be higher levels of government debt (Bortolotti, Fantini, and Siniscalco 2003, 326; Cuadrado-Ballesteros and Peña-Miguel 2019, 304). Privatization thus not only offers governments additional revenue from the sale of the SOE, but also frees up government funds that supported the SOE and provides a new source of tax revenue (Bortolotti, Fantini, and Siniscalco 2003; Cuadrado-Ballesteros and Peña-Miguel 2019, 290). However, it is important to note that studies showing a positive correlation between privatization and fiscal stress have mostly been at the national level, but when examining local governments this relationship becomes weaker (Bel and Fageda 2007, 529; Bortolotti, Fantini, and Siniscalco 2003; Cuadrado-Ballesteros and Peña-Miguel 2019).

Political factors also play a role in privatization. A traditional perspective has been that politicians are interested in gaining political prestige and power by developing the public sector rather than diminishing it (Henig 1989, 655). However, this is not always the case. Montagnes and Bektemirov (2018) examined how politicians and their electorate affect decisions regarding privatization. They found that if the electorate is in favor of privatizing, then the politician is usually in favor as well since it is in their best interest. However, this seems conditioned on the likelihood of the politician being re-elected into office. Politicians will often decide to privatize when they are unlikely to be re-elected and will decide against it when they are assured to be re-elected (1263). Additionally, politicians often choose to either privatize or borrow, as in contracting out the firm, so that they can gain financial resources to pay for current government spending as well as to benefit themselves politically, which has led to over privatization (1265). This is also referred to as mass privatization and can produce suboptimal economic outcomes in countries whose economies are transitioning into a market economy (Nellis 1999). This occurred in several Eastern European countries after the fall of the Soviet Union. In Russia, the government did not have institutions in place to support and facilitate this transition for many firms trying to privatize. Ultimately, the lack of institutional underpinnings became a large deterrent to foreign investment and many Russian firms were unable to attract outside investors. Additionally, the Czech Republic went into a recession in 1998 when its GDP shrunk by 2.5 percent due to its mass privatization policies (Nellis 1999).

One study examined how financial and political influences affect privatization in India by comparing the characteristics of privatized firms with firms that remained publicly owned (Dinc and Gupta 2011). The studies found that larger firms, in terms of their financial capacity, were more likely to privatize. However, SOEs that have a large workforce may hinder privatization efforts. This is likely due to the public's negative perception of privatization and its effects on surplus workers of the firm. Politicians thus may delay privatization efforts in fear of the political repercussions from their constituents (242). Additionally, the study found that the privatization of SOEs is affected by political forces in districts with competitive political races where the party in power often hinders the sale of the firm to reduce public backlash (266). However, the extent to which these factors come into play cannot be generalized to all cases of privatization and is often dependent on the level of government involved as well as the type and size of the SOE (Dinc and Gupta 2011; Gonzalo, Pina, and Torres 2003, 194-195).

During the Reagan administration, privatization became a conservative, right-wing political strategy to limit the role of the government in the private sector and reduce the size of "Big

Government" (Henig 1989, 663). Privatizing efforts undertaken during the 1980s fostered the view that right-wing controlled governments are typically in support of privatization and deregulation policies whereas left-wing governments are opposed. However, the reality is less simplistic. By the 1990s, both right-wing governments and left-wing governments were utilizing privatization policies, possibly influenced by globalization (Schneider, Fink, and Tenbücken 2005, 720-722). In fact, partisan divides over privatization policies greatly diminished during the 1990s in advanced democracies, especially when the country was experiencing economic crises (Zohlnhöfer, Obinger, and Wolf 2008, 115-116).

Several prior studies have examined this relationship between privatization and the government's political ideologies in detail. In their study, Belloc, Nicita, and Sepe (2014) examined how partisan orientation affected liberalization and privatization policies in 30 OECD countries. Liberalization here refers to reduced government intervention in the economy through pro-market policies that ease regulations and other government controls (United Nations 2010). They found that right-wing governments tend to privatize more than left-wing governments and that left-wing governments tend to liberalize more than their right-wing counterparts (Belloc, Nicita, and Sepe 1046-1047). Obinger, Schmitt, and Zohlnhöfer (2014), also found that between the 1980s and the 2010s political ideologies influenced privatization policies in 20 OECD countries (1314). Moreover, a study by Biais and Perotti (2002) found that privatization policies have been used strategically in countries that are politically polarized and have high income inequality by right-wing politicians attempting to remain in power (255-256). In short, there seem to be many political factors that influence privatization policies within governments. Although many of these policies were promoted by conservative, right-wing governments, research has found that left-wing governments have also promoted privatization at times. The next section briefly discusses how governments privatize SOEs.

TECHNIQUES TO PRIVITIZE

Beyond discussing the incentives behind governments' decision to privatize, it is important to discuss how these public firms are transferred to the private sector. There generally are three ways to privatize: asset sales, share issue privatizations (SIP), and voucher privatizations (Megginson and Netter 2001, 380). Asset sales refer to when governments sell an SOE in its entirety to the private sector, whereas SIP refers to when portions of the SOE are sold off in shares to private investors; these two techniques make up most privatizations (342-345). Voucher privatization refers to when the people of a country are given the option to buy shares through vouchers of SOEs, which has been employed more frequently in Central and Eastern Europe (345-346). In other words, how most privatizations occur depends on if the firm is completely or partially transferred to private ownership.

OUTCOMES OF PRIVITIZATION

Many studies have examined the economic and financial benefits that privatizing a public firm can have on its efficiency and profitability (Sheshinki and López-Calva 2003). Specifically, Sheshinki and López-Calva (2003) tested hypotheses that privatization increases efficiency, strengthens the role of the private sector in the economy, improves the public sector's financial health, and frees up resources in the government that can be used in other areas. The study examined both microeconomic and macroeconomic data and found that privatization produces beneficial economic and financial outcomes. Privatization was found to lead to better performance, higher efficiency, increased profits, lower government deficits, positively affect the development of the financial sector, and have a negative impact on employment in the short run, but a positive effect longer-term.

Several studies have also examined the costs that privatization has on the workforce. Arnold (2022, 344) looked at the effects that privatizing Telebrás, a Brazilian telecommunications firm, had on incumbent workers and their wages. The study found that privatization resulted in the reduction in wages of incumbent workers. More specifically, wages decreased about 21 percent after the firm was privatized (345) and decreased approximately 25 percent compared to the control group 10 years after privatization (378). Furthermore, this study found that the privatization of an SOE can have negative impacts on the wages of private sector workers in closely related fields, which suggests that the impacts of privatization can also affect the overall labor market (378-379). In addition, Chamberlain (2015) conducted a difference-in-difference study examining how the privatization of liquor stores in Washington state affected the wages of displaced workers in 2012. The study found that the government employees, who were directly laid off due to the privatization of the state's liquor retailing, ended up making about 17.2 percent less in wages compared to the control group (378-379).

THE VIRGINIA ALCOHOLIC BEVERAGE CONTROL AUTHORITY

The VA ABC operates as a public-private hybrid entity, where the firm is not only the sole liquor retailer in the state, but also serves to administer and enforce any Virginia alcohol-related laws. Due to legislation passed in 2015, the VA ABC transitioned from a state agency to an authority in 2018. This transition allowed the firm to function like a private firm by giving it more flexibility in operating its business while also still maintaining its regulatory duties.

According to the firm's 2022 financial statements, the VA ABC had 395 stores across the state with 4,694 employees and made approximately $1.4 billion in gross sales from liquor store sales alone (Virginia Alcoholic Beverage Control Authority 2022, 5). Profits from the VA ABC, which were approximately $243 million in 2022, are added to the Commonwealth's General Fund which pays for many state programs (60). In addition, the VA ABC collects taxes from alcoholic beer and wine sales as well as an excise tax and a liter tax that goes toward the General Fund. In 2022, the total amount of taxes collected equaled approximately $379 million. The authority also collects penalties for alcohol law violations as well as license fees that contribute to the General Fund as well. In total, the VA ABC contributed approximately $622 million in the 2022 fiscal year (Virginia ABC Communications 2022).

DISCUSSION

In reviewing the motivations driving governments to push privatization policies, there have been several key themes worth discussing. First, prior studies have found that SOEs are inefficient (Bel and Fageda 2007; Dinc and Gupta 2011; Henig 1989; Sheshinki and López-Calva 2003; Yarrow 1986). Inefficiencies are attributed to the presumption that managers at these firms lack the economic and financial incentives to improve the firm's performance. While that may be true, it is important to note that not all SOEs are intended to perform financially well. Take for instance three industries in the United States that are often brought up during privatization debates: education, the postal service, and prisons. The missions of these services do not include turning a profit. For example, the United States Postal Service's mission focuses on providing the American public with reliable and secure communications and services (USPS 2020). Vagliasindi, Cordella, and Clifton (2023) argue that a firm's financial performance should not be the only prime indicator of efficacy, but its objectives should be considered as well (19). The VA ABC could be more efficient in their operations than a private firm due to its very nature of being a hybrid agency. In fact, the VA ABC may be able to lower operating costs due to the firm's centralized organization and business-like operating strategy compared to multiple private firms (Seth 2019).

Second, there is an abundance of economic literature that examines how privatizing has led to firms improving their economic and financial efficiency (Cuadrado-Ballesteros and Peña-Miguel 2019; Henig 1989; Megginson and Netter 2001, 381; Sheshinki and López-Calva 2003). From a microeconomic viewpoint, this makes sense. SOEs often are monopolies by default and thus lack market competition. Ultimately, this argument suggests that SOEs create economic inefficiencies that can result in unfair prices, lower consumer surplus, and increased deadweight loss in the market. The VA ABC does have a monopoly on liquor sales in the state, but privatizing may not result in lower prices for consumers. In a study by Fitzgerald and Mulford (1993), after Iowa privatized liquor retail stores, the sales price increased by 6.1 percent. In addition, the VA ABC is essentially a monopsonist, as it is the only buyer of alcoholic spirits in the Commonwealth, which gives it market power to regulate the prices of liquor. The VA ABC is also more efficient at reducing costs due to its large, and exclusive, operation in the Commonwealth. Economies of scale refer to the cost advantages that a firm has based on its scale of operation. The larger the firm is, in terms of output, the more efficient it becomes because it lowers the firm's average cost (Pettinger 2019).

Third, there are a multitude of political factors that incentivize governments to privatize SOEs examined within the literature (Belloc, Nicita, and Sepe 2014; Biais and Perotti 2002; Bortolotti, Fantini, and Siniscalco 2003; Gonzalo, Pina, and Torres 2003; Henig 1989; Obinger, Schmitt, and Zohlnhöfer 2014). Although it seems like more right-wing politicians push to privatize, left-wing politicians have also favored privatization policies, especially in times of economic turmoil. Other political factors like liberalization and globalization also play a role in privatization. It is interesting to note here that in Virginia only Republican politicians have suggested that the VA ABC should be privatized, most notably by Governor Bob McDonnell in 2010 (Maichle 2010) and Nicholas J. Freitas, who sponsors HB 328.

Lastly and perhaps most importantly, several studies have found that privatization has negative impacts on the labor force (Arnold 2022; Chamberlain 2015; Sheshinki and López-Calva 2003). There seems to be an overall negative impact to the employees of firms that have been privatized, often through loss of employment or reduction of wages. As noted in the introduction, House Bill 328 seeks to completely privatize the VA ABC which could impact the employment status of over 4,500 people currently working for the firm.

CONCLUSION AND POLICY RECOMMENDATION

HB 328 does not aim to transfer the VA ABC to a private firm, but rather completely abolish the firm and deregulate liquor sales in Virginia. These moves could prove detrimental to the Commonwealth because they could result in significant job loss for the employees working at the VA ABC and would negatively impact the labor market in the state. Additionally, this bill could cost the Commonwealth close to a quarter of a billion dollars in losses from their General Fund if the VA ABC gets abolished.

From a microeconomic perspective, this bill does not seem to provide an appropriate policy tool. For one, Virginia is not in an economic deficit (Urban Institute, 2023). In fact, in 2022 the state had a surplus of $2 billion in its General Fund (Porter 2022). Secondly, the VA ABC operates as a private-public hybrid that allows it to run the liquor retail part of the firm like a private business. As a monopsony, the firm has the power to both bring the costs of products down for consumers and operate efficiently in a way private firms have proven unable to do in similar cases.

This brief concludes by recommending that the Commonwealth of Virginia should not privatize the VA ABC as prescribed by HB 328 due to the costs that the Commonwealth would incur. Other privatization techniques could be explored that could increase market competition with the VA ABC by allowing other firms to sell liquor or by selling shares of the firm to the private sector. However, these types of policies are most often used as a way for governments to improve their economy and reduce fiscal debt through privatizing an inefficient SOE or as a way for politicians to somehow retain political power, all of which do not apply in this specific situation.

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