



## Safe and Sound

How the three-tier system of U.S. alcohol regulations helps ensure safe products and protects against revenue loss

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## The Three-Tier Alcohol Regulatory System: Ensuring Safe Products, Protecting against Revenue Loss

More than three dozen people died and many others were seriously injured this past fall in the Czech Republic after drinking tainted spirits, prompting the government there to impose a nationwide ban on the sale of all liquor with 20 percent or greater alcohol content. The impact – and public alarm – reportedly spread to other European countries.

Unfortunately, the Czech Republic incident is far from an isolated case. In both developed and developing countries, counterfeit alcohol has taken lives and harmed people's health on a startling scale. In the summer of 2012, more than 20 people in Honduras died from drinking tainted liquor. In December 2011, the BBC reported that at least 143 people had died after consuming toxic alcohol in India, noting that deaths from toxic alcohol

there are "a regular occurrence." Deaths and injuries linked to adulterated alcohol also have been reported in Russia, China and the United Kingdom.

"We're very concerned about this trend in the availability of fake alcohol. It's not just about false bargains, counterfeit spirits and wine could be lethal."

- Ron Gainsford, chief executive of the U.K.'s Trading Standards Institute  
Source: [www.drinkaware.co.uk](http://www.drinkaware.co.uk)

Beyond the tragic human cost, counterfeit alcohol creates an enormous financial impact.

In the Czech Republic alone, the government expected to forego millions in liquor taxes and businesses were projected to lose millions in revenue because of the 2012 incident. Meanwhile, the British government noted in a March 2012 report that alcohol fraud, which has grown in the U.K. in the last two decades, costs as much as 1.2 billion pounds (\$1.82 billion) each year in lost tax revenues, "depriving the government of revenue to fund vital public services." It stressed the importance of tackling fraud effectively "to ensure that honest businesses can compete fairly."

### The Benefits of the U.S. Alcohol Regulatory System

The United States stands in stark contrast. The reason we have so few problems with counterfeit and tainted alcohol is because of our state-based, three-tier alcohol regulatory system. The Constitutional amendment that repealed Prohibition also gave states the authority to regulate alcohol. Most states adhere to an effective system that requires alcohol to be sold through three separate market tiers: manufacturers/suppliers, wholesalers and retailers, each with its own service focus. This proven system balances alcohol availability, price and promotional practices. It uses checks and balances from one tier to another to enforce many provisions.

Two major benefits of the three-tier system – helping ensure public safety, specifically safeguarding against tainted or fake alcohol, and protection against revenue loss – are the focus of this report. A greater understanding of these fundamental benefits is needed because, while the system successfully supports a healthy and efficient alcohol marketplace, strong forces are at work seeking alcohol deregulation in the U.S.

#### The U.S. three-tier alcohol regulatory system ensures:

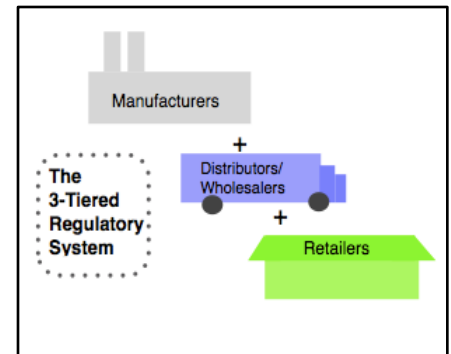
- ✓ Product tracking to prevent the sale of tainted and counterfeit alcohol
- ✓ Efficient tax collection

### How the three-tier system works

In general, the system requires businesses operating in the three market tiers to be separately licensed and owned, independent of each another. This structure prevents marketplace domination by large companies that would seek to greatly increase alcohol sales through aggressive practices, or by controlling the entire alcohol distribution chain, from manufacturer to consumer. This closed distribution system also helps prevent adulterated and contaminated products from reaching consumers because alcohol is required to go from a licensed manufacturer to a licensed distributor to a licensed retailer.

Operators in the middle tier – licensed distributors and wholesalers – collect excise taxes and track products, a function the government would otherwise perform at extra taxpayer expense. Thanks to product tracking, spoiled or recalled alcohol can be quickly identified and pulled from shelves. Because licensed distributors visit licensed retailers regularly, they notice a product that they did not supply. They are obligated to immediately report such products to the appropriate regulatory agency. Under this system, it would be difficult for a licensed retailer to systematically sell counterfeit or untaxed products. And, a distributor is unlikely to jeopardize its license by offering a fake product to a licensed retailer.

The three-tier system also helps ensure consumer confidence in the alcohol industry. Even the best licensed manufacturers can mistakenly produce a tainted batch or product. In today's market, minor problems with product quality can cripple a company or disrupt a commodity market. This is much less likely to happen in the U.S. alcohol marketplace because, as noted, licensed alcohol wholesalers must track every bottle and can. This minimizes harm and can save a business. A recent example involving Heineken USA Inc. illustrates the system's consumer-protection benefits. Last year, the company voluntarily recalled several products and packages in specific states because of a defect in 12-ounce brown bottles used for certain batches of beer, creating the potential for small grains or particles of glass to separate from the inside lip of the bottles and fall into the liquid. Heineken said the defect was detected through its routine quality inspections. When the recall was announced, Heineken said it was believed the number of affected bottles was significantly less than 1%, and that there had been no reports of consumer injuries. But it decided on the recall as a precaution. As a result, Heineken and the distributors accounted for 100% of the impacted produced and reduced all risk to the consumer. See also <http://www.youtube.com/watch?v=BQsVmvGfWmg>



A 2009 report, prepared by KPMG for the National Beer Wholesalers Association, examined the structure and administration of various state and local taxes imposed on the sale and distribution of beer across the states. It found that the three-tier system was part of a regulatory system that helps ensure efficient compliance with beer taxes. "These regulations, taken together, create the opportunity to monitor the flow of alcoholic beverages in the state, provide state regulators and tax administrators with a limited number of points to tax and/or exercise control over the flow of alcoholic beverages, limit opportunities for contraband (i.e., untaxed) alcoholic beverages to enter the distribution chain and ensure compliance with the various tax systems," wrote the report's author, Harley Duncan of KPMG and formerly the Executive Director of the Federation of Tax Administrators, "In particular, requirements that suppliers must sell only to licensed wholesalers and that retailers may purchase product only from certain licensed wholesalers is fundamental to ensuring compliance with beer taxes in an efficient manner. Without these controls, the level of resources necessary to achieve any given level of compliance would be substantially greater than at present."

### The Health Dangers of Tainted Alcohol

While legitimate alcohol is made with ethanol, which is safe to drink in moderation, counterfeit alcohol is an extreme threat to public health because it often is made with chemicals not fit for human consumption.

Drinkaware, an U.K. charity aimed at improving U.K. drinking practices, noted that commonly used substitutes for ethanol include chemicals in cleaning fluids, nail polish remover and automobile windshield washer fluid, as well as methanol and isopropanol, which are used in antifreeze and some fuels.

"These other types of alcohol can produce similar effects to ethanol in terms of making you feel tipsy," said Drinkaware's chief medical adviser, epidemiologist Paul Wallace. "But they are also potentially very dangerous."

#### Did you know?

-Nearly 30 percent of alcohol consumed globally by adults is unrecorded\*, according to the World Health Organization.

\* alcohol that is untaxed and outside the usual system of governmental control, because it is produced, distributed and sold outside formal channels

Indeed, health authorities say drinking counterfeit alcohol made with poisonous methanol, even in small amounts, is dangerous and can cause vomiting, convulsions, blindness, coma and death. In an information piece outlining the dangers of counterfeit products, Europol, the European law enforcement agency, highlighted a case in Turkey where 23 people died after consuming counterfeit alcohol containing lethal levels of methyl alcohol, or methanol.

In countries such as the Czech Republic where counterfeit alcohol has caused death and injuries, restoring the public's trust in alcohol products can be slow going. And it can be difficult to remove tainted alcohol from the market. A poll conducted in late November 2012, in the wake of the alcohol poisonings in the Czech Republic, found that only 18 percent of Czechs consider the consumption of liquor served in a bar to be risk free. The poll also found that neither new stamps nor special certificates proving alcohol origin shore up public trust since

only one-sixth of those polled follow them when buying liquor. Moreover, a published report concerning the poll noted that police believed some 5,000 liters of poisonous alcohol were still in circulation.

## Threats to U.S. Alcohol Regulatory System

The United States is experiencing a trend toward increased alcohol affordability, accessibility and marketing. There is growing pressure toward deregulation so that alcohol can be marketed like any other consumer product, with few restrictions. In Washington state, a successful ballot initiative altered the three-tier system by privatizing liquor and wine sales. The initiative has sparked a wave of legal wrangling regarding implementation of new rules.

In some cases, states grappling with public budget shortfalls eye deregulation as a way to boost revenue and restore government coffers. In other cases, forces that seek deregulation wrongly contend that the three-tier system is antiquated, designed to stem organized crime and other problems of Prohibition, when in fact most alcohol regulations aim to prevent companies from dominating local markets, a major problem that predated Prohibition, and to protect public safety. Yet another threat to the system is so-called "deregulation by defunding." In Missouri, for example, state budget cuts in 2010 left just a handful of alcohol agents to monitor thousands of liquor licensees. Cuts of this magnitude increase the risk to the consumer for both revenue loss and safety due to non-tax paid and unsafe products. Other states have experienced similar circumstances.



One of the dangers inherent in the push toward alcohol deregulation is the potential for adoption of overly simplistic solutions that don't take the entire system into account, leading to unintended consequences that undermine the three-tier system's functions of preventing fake and tainted alcohol, efficiently collecting taxes and balancing prices. In the U.K., alcohol regulations were chipped away over decades, and today the country is grappling with severe alcohol problems and how to implement a system of effective policies that will curb what has become a virtual alcohol epidemic.

Despite threats to the U.S. three-tier system, surveys make clear that deregulation advocates are markedly out of step with most of the American public. Consider the results of a recent nationwide survey conducted for the nonprofit Center for Alcohol Policy. It found in part that:

- 76 percent support the rights of states to set their own laws and regulations that require alcohol to be sold under the three-tier system.
- 89 percent agreed that "all alcohol sold in my state should come through a licensed system which effectively tracks the steps it takes from the producer to the consumer."

The same survey also found that 88 percent of respondents agreed it is easy for adults to find a wide variety of beer, wine and liquor in their community. This finding points to a couple other key attributes of the three-tier system: consumer choice and a leveling of the playing field so that smaller businesses can compete in the alcohol market.

Indeed, the system promotes a vibrant alcohol industry. Take beer, for instance. In a recent opinion piece, Charlie Papazian, author and founder of the Association of Brewers, argued that, if not for Prohibition and the three-tier system that emerged in its wake, "I don't think good things would have happened, and I don't think we'd be enjoying the time now celebrating 2,400 breweries."

The commentary, published at Examiner.com, acknowledged that Prohibition was "ugly." But without it Papazian believes the beer industry would have evolved much like it has in Europe and other places in the world where restaurants and bars are under contract with a brewery to serve their beer exclusively. Small brewers cannot get their product to market and the consumer has a very limited choice of products.

The fact is, all of us – licensed alcohol manufacturers, distributors and retailers, substance abuse prevention and treatment providers, public health authorities, law enforcement officials and consumers – have important roles to play in raising awareness about the vital functions of the three-tier system and the degree to which the public supports it. We must ensure that the system is well understood, particularly by our elected leaders, so its benefits are not taken for granted or weakened through piecemeal deregulation that seriously undercuts public safety and cost-effective tax collection – a scenario from which no one would benefit.

*This report was produced by Public Action Management in association with Barry Finnemore, a writing and editing consultant. For more information, please contact Public Action Management President/CEO Pamela S. Erickson at [pam@pamaction.com](mailto:pam@pamaction.com).*