Wine Economics

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8

The Regulation of Supply

If ships generally function better than states, this happens for the simple reason that everyone accepts the role he is expected to play, while in states, generally, the less someone knows, the more eager he is to command.
—A phrase attributed to Massimo d'Azeglio (1798–1866)

Market regulation refers to all policies discussed in this second section of the book, ranging from the protection of health to the reduction of asymmetries, from the improvement of product quality by imposing strict minimum standards to the restoring of the market equilibrium. The regulation of supply, therefore, is a subset and consists in the array of instruments and policies adopted in different countries to influence the production (directly or indirectly through sales) of wine.

As already mentioned in the introduction, over time Europe and the United States have adopted completely different policies. In Mediterranean Catholic countries there has always been a strong culture of moderate daily consumption of wine during meals. In northern Protestant countries, instead, beer and also spirits are the prevalent beverages, overall consumption rates are lower, and public concern about the negative consequences of alcohol abuse is higher. In their empirical study of alcohol consumption patterns in the United States, Holt et al. (2006) found the same differences between these two major religious groups, with Catholics drinking more than Protestants.

These cultural and historical backgrounds have strongly affected the alcohol policies in the two continents. As the European Union was gradually being established after World War II, France had a dominant impact on the rules of the Common Market Organization (CMO). In this country wine is part of the national identity, and there is a very large number of people involved in its production, distribution, and sale (Banerjee et al., 2010). Banning alcohol would have been extremely unpopular among voters because of opposition from both consumers and producers. Wine makers have shown their determination and political strength during massive revolts (for example in Languedoc in 1907 and in 2005, and in Bordeaux in 1974–1975; see Colman, 2008, pp. 18, 51–52, 55). Prohibition and policies to contain alcohol consumption were politically unthinkable and the target of policy makers was to reduce oversupply to ensure positive returns for wineries. This dirigisme was acquired by the European Union; they applied the same regulatory instruments adopted by France in the previous decades (incentives to uproot the vineyards, subsidies to distill wine excess, etc.). The main focus was neither public health nor consumer welfare but rather producers' economic wealth.

However, in the United States, religious Protestant temperance movements gained political influence over the second half of the nineteenth century until they managed to outlaw alcohol production and consumption. The focus of policy makers here was public health, not producers' wealth. When Prohibition was repealed in 1933, the new law provided single states and even counties the power to regulate every aspect of the production and sale of alcohol in order not to disappoint these movements. The legacy of Prohibition was "a chaotic patchwork of state regulations for producers and consumers to navigate" (Colman, 2008, p. 34). It was the temperance movements, not those of alcohol producers, that politicians did not want to disappoint—a completely different perspective.

This chapter starts by discussing the theoretical reasons which justify public intervention to regulate the market. It goes on to describe the sources of law in Europe and the United States, underlining which are the most important for the wine sector in the two continents. The third and fourth sections explain how the socioeconomic context and politics have shaped the regulation of agricultural markets in the two areas, both with their own inefficiencies.

8.1 Market Regulation

8.1.1 Reasons for Market Regulation

The need to regulate a market arises from failures, as illustrated in the previous chapters. One type of failure, discussed in chapter 6, is linked to the presence of information asymmetries that determine an inefficient allocation of resources. A second one, analyzed in chapter 7, is connected to the externalities that generate suboptimal or super optimal levels of production or consumption. Finally, a third one derives from the need to ensure competition among firms when the existence of economies of scale lead to the creation of natural monopolies. This latter case has not been discussed in detail because the wine market is characterized by the presence of thousands of companies spread across five continents with a very high level of competitiveness (Milhau, 1953).[1]

However, market regulation sometimes aims to do the opposite—that is, reduce competition to avoid the erosion of firms' profits. This is the case with the European Union's Common Agricultural Policy (CAP), whose main target is to ensure reasonable prices and good standards of living to the community of farmers by subsidizing producers and restricting the supply (see appendix 8.1). This is not a market failure;

with falling business opportunities, some firms would leave the market. Rather, it is the response of politicians to the pressures of organized defiant groups of interest. In the United States the temperance movement has been politically stronger than that of alcohol producers; therefore public policies have regulated the supply by prohibiting the production or hindering alcohol demand.

8.1.2 Measures to Prevent Market Failures

To counter abuse of a dominant position, information asymmetry, or negative externalities, public authorities can adopt a series of economic incentives or regulatory measures. The latter range from guaranteeing competition in the market (antitrust activity) to imposing labeling rules and minimum safety standards (at work, in public and private transport, the wholesomeness of food, the quality of teaching in schools, and universities, etc.). To resolve or at least mitigate these failures, four different—but not mutually exclusive—strategies may be adopted that give increasing power to the state at the expense of private individuals: self-discipline, private resolution of disputes, regulation, and finally, public ownership.

Self-discipline requires people to behave in a correct way and not to abuse others. This solution is obviously purely theoretical as the world is full of individuals and businesses that pursue their own interests and savagely trample on others. The private resolution of disputes means that individuals settle judicial controversies by relying on current regulations. The third solution requires regulation through the introduction of new laws and the possible establishment of a special authority with the task of overseeing the market to prevent the emergence of conflicts. The most restrictive policy consists in the state taking over total control of the market through nationalization.[2] These last two solutions have often been adopted in Western Europe, though there has been a progressive privatization of state monopolies since the 1980s resulting in the liberalization of markets and the establishment of specific guarantor authorities.[3]

8.1.3 Debate About Market Regulation

In the last hundred years, regulation by public authorities has grown steadily, but the debate about whether it has contributed or, on the contrary, hindered economic growth is still alive. There are three main theories on regulation (for an excellent review of the literature, see Shleifer, 2005). The first is about public interest and refers to Pigou (1920), the second is the contract theory associated with Coase (1960), and the third is Stigler's (1971) capture theory. The theory of public interest supports the need for state intervention in the economy, starting from the two assumptions that markets often fail and that public authorities are able to solve a problem through regulation. This theory was widely used during the twentieth century, and above all by socialist governments, to justify public intervention in the economy. It also indicates the measures to be taken—for example, price control in the case of a natural monopoly—or environmental, safety, and quality standards to avoid negative externalities of production or consumption.

These ideas were strongly criticized by the Chicago school of economics that claims that markets are able to solve almost all problems spontaneously through incentives or bargaining mechanisms among parties. If a product does not meet certain quality or safety standards, the consumer turns to a competing company, just as an employee changes company when economic or working conditions are unsatisfactory. When private negotiations are ineffective, efficiency can be restored by the courts (Coase, 1960), provided that they are able to enforce the laws and compensate for any injustice suffered.

State intervention is considered harmful because its employees are often incompetent or corrupt. Stigler (1971), in fact, goes even further in his criticism, going down to the very roots of the theory of public interest, and questions whether the state is actually a benevolent, competent, and impartial planner. In actual fact, governments often favor, rather than hinder, the interests of power groups. Even when they really want to pursue public interest, civil servants are often ill-prepared and end up producing effects that are very different from those intended.

While the theory of public interest is excessively pessimistic about the self-regulatory ability of the market, the same holds for the optimism shown by the Chicago school. Self-regulation works up to a certain point, beyond which it becomes anarchy in which the strongest, and not the righteous, often dominates. Judges can be corrupt or politicized, and the courts as well as governments are made up of men with their own weaknesses (Shleifer, 2005), so self-regulation suffers from very similar problems to regulation.

From a practical point of view, there is no single solution to all problems in the management of an economy. The choice of the best strategy must be carefully weighed and contextualized. Disagreements in condominiums are resolved most of the time amicably for the sake of peace and quiet, but there are things that the market often does not do spontaneously that have important consequences on the well-being of society. One example is the use of active and passive safety systems installed in cars that spread significantly after they were introduced by law. Moreover, people often are not fully aware of the negative consequences that can result from their actions, and compensation only partially repays the harm suffered. Now, who decides the rules in Europe and in the United States?

8.2 The Sources of Law

Modern legal systems have various sources of law. In the most important wine-producing countries the relationship between sources are regulated by hierarchical and chronological criteria. The hierarchical criterion provides that, when two conflicting laws come from different sources, those of the lower rank are invalid. The chronological criterion requires that the most recent source in time prevails over sources of the same level in accordance with the principle of *lex posterior derogat legi priori* (more recent laws modify earlier ones). The hierarchy of sources is listed below.

1. *The constitution*: It expresses broad principles and does not deal directly with agriculture.
2. *International treaties and agreements*: They regulate trade among countries, subsidies, and import duties and tend to be reciprocal.
3. *European laws (in Europe) and federal laws (in the United States)*: They apply to all countries/states within the union/federation and are passed by the European Parliament and by the US Congress, respectively. They are particularly important in Europe[4] because the European Union has been strongly influenced by French dirigisme and has regulated almost every aspect (e.g., the wine classification system, the maximum number of hectares and wine that countries can produce, the amount of subsidies to uproot vineyards and distill wine, etc.).
4. *National laws (in Europe) and state laws (in the United States)*: In this case they are more relevant in the United States because of the US Constitution's Twenty-First Amendment that repealed Prohibition in 1933. In order not to disappoint the temperance movement which was politically very strong—especially in religious areas—the same amendment gave local authorities (states and even counties) the power to regulate the production and distribution of alcoholic beverages (see section 8.4).
5. *Local laws*: As mentioned before, they are more important in the United States. In Europe, local authorities have some degree of autonomy in the regulation of the opening hours of shops, restaurants, and clubs. However, in the United States the Twenty-First Amendment gives much more power so that states and counties can even decide to stay "dry" and forbid the production and sale of alcohol.
6. *Judgments of courts*: They matter in the absence of written laws, which in the wine sector is very unlikely since it is heavily regulated.
7. *Customs*: Behavior repeated by people in the belief that they are following a law or that other individuals do the same. There must, therefore, be repetition over time and the belief that it is right or done by everyone.

This brief outline clearly shows the prominent role of the European legislature within the European Union and of state and local laws in the United States. The regulation of the wine classification has already been discussed in chapter 6. In the next two sections we will focus on the regulation of supply in the European Union and in the United States respectively.

8.3 Regulation of Supply in the European Union

8.3.1 Tools, Origin, and Development of the European Wine Policy

Of the four solutions mentioned at the beginning of the chapter (self-discipline, private dispute resolution, regulation and public ownership) the third is the most frequently adopted in the wine sector in line with the entire agri-food sector. It is implemented through the enactment of strict laws on the wholesomeness of drinks and on the wine-making practices allowed as well as through the creation of appellations of origin and rules on labeling. The EU wine system is undoubtedly the most regulated in the world. The legislature establishes practically everything—from which vines are allowed to the borders of each appellation or geographical indication and from wine-making practices to labeling (Marks, 2015, pp. 127–128).

Some measures have been introduced to protect both producers and consumers. Others, however, such as the attempt to influence supply to correct the disequilibrium in the market, reflect the interests of the winery lobbies and are aimed at redistributing income from potential newcomers (outsiders) or from consumers to existing producers (insiders).[5] Since the 1960s, in fact, the European Union has guaranteed a minimum price and the purchase of accumulated or distilled surpluses. In doing so, however, the subsidies system has accentuated structurally[6] rather than solved the problem of surpluses and has tried to remedy the situation by introducing planting rights and incentives for the grubbing up of vineyards.

From the very beginning, the European wine policy has mirrored French policy regarding both the wine classification system and supply regulation policies (Meloni and Swinnen, 2013). The system of appellations was, in fact, established in France in 1935 (the Bordeaux areas had already been classified in 1855) and was later extended to all EU countries through national laws (such as in Italy with law 930/1963), a year after the approval of the Council Regulation No. 24/62 establishing the first wine CMO.

Policies for restricting supply also originated in France where producers suffered fierce competition both from Italian and Spanish viticulturists as well as active French producers in the Algerian colony in the 1920s. Italian and Spanish competition was countered by raising customs duties while the Algerian threat led to the introduction of the Appellation d'Origine Contrôlée (AOC) system in 1935 to prevent the Algerian wines from being labeled as French (Colman, 2008, pp. 20–22). To restore the balance between the production and consumption of wine, between 1931 and 1935 the French authorities passed the *Statut Viticole* that contained various measures to restrict supply (such as the obligation to either store or distill part of excess production), the taxation of companies with productivity per hectare above a certain threshold, a ban on planting new vineyards for companies with more than ten hectares, and incentives for grubbing up existing vineyards. These measures were designed on the whole to hit primarily the Algerian producers who had, on average, large plots of intensively cultivated land and marketed low-quality wines, passing them off as French (Birebent, 2007; Simpson, 2011).

The incentives for grubbing up vineyards, though considerable (7,000 francs per hectare), proved to be ineffective. Only the worst producers, in fact, abandoned the cultivation of some land, and the overall impact on the quantities produced and the average quality was negligible (Milhau, 1953). World War II and the German occupation led to serious damage to the French vineyards so the *Statut Viticole* was set aside. In the years of the immediate postwar period, the focus was on the reconstruction of the production potential. However, in less than a decade, the age-old problem of overproduction reemerged, and the *Code du vin* was introduced with objectives and instruments similar to those of the *Statut Viticole*: incentives for the grubbing up of vineyards, penalties for high yields, and the management of overproduction through stock accumulation and crisis distillation (Meloni and Swinnen, 2013). Once again incentives for grubbing up did not have the desired effect since it was mainly the producers in regions where there had already been a spontaneous decline in viticulture that responded to economic incentives (Bartoli, 1986).

The establishment of the first wine CMO in 1962 led to a gradual harmonization of legislation in the six member countries, among which France and Italy had dominant positions with over 90 percent of production. In 1970 a compromise was reached between the more interventionist French and the more liberal Italian positions. In response to French requests, a guaranteed minimum price was established with the Council Regulation (EEC) Nos. 816/70 and 817/70 through support given to the accumulation of stocks and the distillation of table wines. However, in line with the Italian model, no regulation of planting rights or incentives for grubbing up were introduced (Arnaud, 1991).[7]

In the early 1970s excess production, partly favored by European support for the production of low-quality wines, increased and absorbed a growing amount of EC resources. French wine makers felt threatened by the competitiveness of Italian wine prices, which was heightened by the devaluation of the Italian currency lira. To put a stop to this "wine war" and reduce the size of the "European Wine Lake," the Council Regulation (EEC) No. 1162/76 introducing incentives for grubbing up vineyards and planting rights was passed in 1976. This last measure was similar to the quota system for milk and sugar.[8] So, in a short time, the French model became dominant, shaping EC legislation in its own image. This interventionist policy aimed at restricting supply has continued over the decades. Attempts by legislators to restrict production have proved, however, to be ineffective because of an increase in the productivity of the land. As a result, a new production peak was recorded in the 1980s (Corsi, Pomarici, and Sardone, 2004). Council Regulation (EC) No. 1493/1999 contains a series of measures including the provision of funds for the promotion of Community wine abroad.

Council Regulation (EC) No. 479/2008 on the common organization of the wine market pursued the ambitious goal of reducing waste and standardizing the European wine market to make it more efficient, transparent, and competitive. It included numerous measures. Some of them were praiseworthy and included the elimination of subsidies for the destruction of surpluses,[9] support for company investments, checks on compliance with production regulations that were no longer made by consortia but by third parties, and measures to ensure product traceability.[10] Others, however, were much more questionable, as for example the new Vino da Tavola (VdT), protected geographical indication (PGI), and protected designation of origin (PDO) classification system, which has been discussed before, as well as legislation on the planting, replanting, and grubbing up of vineyards that severely limited the planting of new vineyards and provided rewards for uprooting existing ones.[11] Green harvesting also aimed to restrict production by providing subsidies to producers. It consisted in "the total destruction or removal of grape bunches while still in their immature stage, thereby reducing the yield of the relevant area to zero" (Council of the European Union, 2008, Article 12), which should not be confused with the thinning out of bunches that is part of winter pruning. The whole regulation moved toward restrictions on production to increase the average price level and support farmers' incomes, as clearly shown in Recital 5:

> Increasing the competitiveness of the Community's wine producers; strengthening the reputation of Community quality wine as the best in the world; recovering old markets and gaining new ones in the Community and worldwide; creating a wine regime that operates through clear, simple and effective rules that balance supply and demand; creating a wine regime that preserves the best traditions of Community wine production, reinforcing the social fabric of many rural areas, and ensuring that all production respects the environment. (Council of the European Union, 2008)

It is also evident in Recital 2, summarizing the problem to be solved that the attention of European legislators was directed toward producers, not consumers:

> Wine consumption in the Community has been steadily diminishing and the volume of wine exported from the Community since 1996 has been increasing at a much slower rate than the respective imports. This has led to a deterioration of the balance between supply and demand which in turn puts producers' prices and incomes under pressure. (Council of the European Union, 2008)

The only (small) consolation remains the mea culpa, in the third recital, about the failure of past EC policy:

> Not all the instruments currently included in Regulation (EC) No 1493/1999 have proved effective in steering the wine sector towards a competitive and sustainable development. The market mechanism measures have often proved mediocre in terms of cost effectiveness to the extent that they have encouraged structural surpluses without requiring structural improvements. Moreover, some of the existing regulatory measures have unduly constrained the activities of competitive producers. (Council of the European Union, 2008)

Even if we did agree with the objectives of the expensive measures that aim to favor the grubbing up of vineyards but totally fail to consider the wellness of consumers, the problem of this policy lies in the fact that the European Union is not a closed economy and is no longer the exclusive producer of wine. "New" producers (primarily Australia, New Zealand, Chile, South Africa, Argentina, and the United States) are invading world markets with their products, and this tends to nullify, or at least strongly weaken, the effects of the EC strategy to restrict production in the European area. All this is happening in spite of the considerable cost of more than €1 billion incurred by the European Union for the three-year period 2009–2011 to incentivize the eradication of often unprofitable vineyards.

Above all, one wonders whether it would not have been better to have left the market to itself. In time, the worst producers would have left the market spontaneously, and there would have been more resources to allocate to the innovation of the most competitive companies wishing to focus on quality. The EC legislators' attempts to rebalance supply and demand, which have been going on for decades, appear costly and useless in the now globalized economy. The level of incentives for grubbing up (a one-off payment of between €1,740 and €14,760 per hectare depending on the yield) does not seem enough to encourage an entrepreneur to leave his business, unless it is running at a bad loss, in which case the grubbing up would happen without any subsidy. Some observers believe that we must offer a way out for entrepreneurs who are no longer competitive and help them to convert production. It would be interesting to see the costs and benefits of this policy in the future with the hope of not reading in the next wine CMO another mea culpa like those in Article 5 quoted above.

8.3.2 Recurring Cycles in the European Wine Policy

Even though the economic system is changing rapidly, the problems and their solutions do not seem to have changed substantially in the course of time. In an article that appeared a number of years ago in the *Economic Journal*, Charles Gide analyzed the causes of the crisis in the French wine market in a lucid and precise manner. The author noted how, according to many economists, the main cause of the collapse in wine prices was excess production, in which case there was no better solution than to rely on the ancient law of supply and demand. A fall in prices would induce some farmers to abandon the cultivation of vines, and this would lead to a rebalancing between supply and demand. According to the author, however, the true root of the problem was not excess production but rather a lack of demand, a much more serious question. The production of wine can be limited by law, but individuals cannot be forced to increase their consumption of alcoholic drinks. Gide also commented that wine makers should have restricted their production spontaneously to restore a balance between supply and demand and focused on quality, not quantity. Interestingly enough, Gide's article was published in 1907![12]

In looking at today's Europe, there is no point in deluding ourselves. With constantly falling domestic consumption and increasing international competition, restrictions on supply and grubbing-up premiums will certainly not solve the long-standing problem of the imbalance between supply and demand. After more than a hundred years, the European Union has finally taken note and decreed, again with Council Regulation (EC) No. 479/2008, the liberalization of the sector starting from January 1, 2016, through the abolition of planting rights, incentives for grubbing up vineyards, and subsidies for concentrated and corrected musts as well as the abolition of distillation measures.

Before proceeding with total liberalization, a final grubbing-up program was planned for a total of 175,000 hectares between 2008 and 2011. It was designed to encourage the exit of the less competitive wine makers from the market and the restructuring and/or conversion of vineyards to improve the competitiveness of those who intended to remain in business. The system of planting rights had to cease on December 31, 2015, unless national governments decided to postpone this date by three years. In the three years from 2007–2008 to 2010–2011, 272.528 hectares were removed in Europe (table 8.1), of which 161,164 received EC incentives (59 percent of the total uprooted, 5 percent of the area planted in 2007–2008).

Regulation (EU) No. 1308/2013 establishing a common organization of agricultural product markets approved the abolition of all the previous restrictions on supply: the milk quota system from April 1, 2015, sugar quotas from October 1, 2017, and vineyard planting rights from January 1, 2016. Producers' lobbies, however, have fiercely disputed what they define as the "wild liberalization" of the market and have succeeded in winning a postponement leading to "controlled" liberalization. Up to now the rights to plant a vineyard had to be bought from another producer, but during the transitional period from 2016 to 2030 free permits will have to be requested based on the availability of single states. National authorities may issue new authorizations for an annual amount not exceeding 1 percent of the national vineyards, with the possibility of reducing this level and concentrating the emission in the most valuable areas, taking into account the recommendations of the protection consortia. Rights and permits present a number of differences. Rights, in fact, last eight years and can be transferred or purchased while permits have a three-year term, are not transferable, and are free of charge. Despite these differences, however, the two instruments pursue the same objective of restricting production. Two steps forward and one step backward, therefore, in an overall picture that in half a century has been made up of high and low points.

8.4 Regulation of Supply in the United States

8.4.1 The Temperance Movement and Prohibition (Volstead Act)

The history of market regulation in the United States is completely different from Europe and is closely linked with the temperance movement, whose ultimate goal was abstinence from alcohol (see Colman, 2008, pp. 29–36). In the nineteenth century its

Table 8.1
Change in the rooted surface and uprooting with EU subsidies, 2007/2008–2010/2011

	Rooted surface			Change 2007/2008–2010/2011		
Country	2007/2008	2010/2011	% Change	Change 2007/2008–2010/2011	Of which uprooted with subsidies	% of the total uprooted with subsidies of the total planted with subsidies in 2007/2008
Spain	1,098	968	–12%	–130	94	9%
France	848	806	–5%	–42	23	3%
Italy	700	66	–5%	–36	28	4%
Portugal	240	236	–1%	–3	4	2%
Germany	102	102	0%	0	0	0%
Greece	71	67	–5%	–4	2	3%
Austria	50	46	–8%	–4	1	2%
Luxembourg	1	1	–1%	0	0	0%
Hungary	81	72	–12%	–10	6	7%
Slovak Republic	20	19	–9%	–2	1	3%
Czech Republic	17	17	0%	0	0	0%
Slovenia	17	16	–8%	–1	0	1%
Cyprus	13	9	–33%	–4	2	13%
Malta	1	1	–24%	0	0	0%
Romania	181	182	0%	0	1	0%
Bulgaria	104	69	–34%	–35	0	0%
Total EU	3,549	3,277	–8%	–272	–161	5%

Source: Author's calculations using data from Tables 1 and 2, Annex II of the EU (2012).

influence spread across the United States; the first city banning alcohol and declaring itself "dry" was Portland (Maine) in 1843, followed by the state of Oregon in 1844, which forbade the sale of spirits, and then by Evanston (Illinois). The fight against alcohol slowed down during the American Civil War because Congress needed to raise taxes to finance the army. In fact, the alcohol industry became an important source of state revenues and was thus legitimated. The business was large, and it was easy to make producers and consumers pay taxes.

After the end of the Civil War the temperance movement gained political strength again, and by 1919 they had managed to pass Prohibition regulations in thirty-three of the forty-eight states. After a first attempt in 1875, Congress finally approved a national ban (the Volstead Act) on alcohol production, sale, and consumption in 1919 (the law came into effect in January 1920). The Association Against the Prohibition Amendment (AAPA) managed to convince the United States that alcohol had harmful consequences not only on society but also on the economy by reducing workers' efficiency, especially when working with the technologically advanced machines that recent innovations had introduced.

This was a terrible blow for the infant American wine industry. During what President Herbert Hoover called "the noble experiment," the number of wineries fell from more than one thousand to around 150 in California. Wine production survived thanks to three loopholes: wine for sacramental use in churches, wine for medicinal purposes, and grapes sold for home production. In fact, each household was allowed to produce a small amount of "nonintoxicating" cider and fruit juice.[13] Therefore, the paradox of Prohibition is that, during the 1920s, due to the ban of alcohol, the acres under vines increased, even though the quality of produced wine obviously fell.

The illegal alcohol industry also flourished thanks to the weak enforcement of the Volstead Act, which was carried out by officers from the US Department of the Treasury instead of the US Department of Justice. In 1920 the Treasury Department established the Bureau of Prohibition for this purpose, though it did not have much interest in fighting illegal alcohol trade because there were no excise taxes to collect. Only in 1930 did this bureau become part of the Department of Justice.

The Volstead Act produced a series of negative effects on the US economy. First of all, a number of economic activities involved in the production and distribution of alcoholic beverages had to close down. Second, many states had to face a significant reduction in tax revenues. Third, the balance between benefits and costs became uncertain over time. In fact, after a first period of a marked fall, per capita consumption of alcohol returned to around 70 percent of pre-Prohibition levels while corruption among public officers was spreading and the costs to enforce the law were booming.

The Volstead Act was also increasingly criticized because mass violations of Prohibition engendered widespread disrespect for the law, a condition usually termed "lawlessness." In his inaugural speech in 1929 President Hoover declared: "Our whole system of self-government will crumble either if officials elect what laws they will enforce or if citizens elect what laws they will support. The worst evil of disregard for some law is that it destroys respect for all law" (Hoover, 1929). Just as the Anti-Saloon League had been the main promoter of Prohibition, the AAPA dominated the making of repeal. This association was led and financed by some of the richest US entrepreneurs, such as Pierre du Pont of du Pont Chemicals and John Raskob of General Motors. The main reason for their involvement was economic: by restoring alcohol taxes they hoped to reduce the fiscal pressure on their firms.

The Great Depression, which started in 1929, provided valuable support for the repeal for two reasons. First, "it destroyed any credibility for the long-standing prohibitionist claim that Prohibition brought prosperity, and it fueled the new fantasy that repeal would end the depression by putting men back to work by stimulating the economy" (Levine, 1985, p. 72). Second, public authorities were more and more concerned about the discontent of people caused by both the economic situation and the alcohol ban that had given rise to protests and riots in major US cities. The 1917 Bolshevik Russian Revolution promoted a widespread "Red Scare," especially after the 1919 series of bombings by the Italian anarchist Luigi Galleani and the 1920 terrorist attack in Wall Street, which killed thirty-eight people and injured hundreds more. The idea of leaving young, unemployed people, with limited social and marriage opportunities because of the economic difficulties and without the chance to drink any alcoholic beverage, was risky in a period when Communism was gaining consensus all over the world. This problem became even more severe after the 1929 crisis, which fed people's anger toward entrepreneurs and capitalists. Over time the consensus around Prohibition shrank until the Congress approved the Twenty-First Amendment in 1933, voiding the Eighteenth Amendment.

8.4.2 The Politics of Repeal and the Three-Tier System

When Prohibition was repealed, every state and even every county was allowed to decide how to regulate the alcohol market. First, they had to decide if they wanted to remain "dry"—thereby forbidding the production and sale of alcoholic beverages—or become "wet." Then, if they opted for the second alternative, every local government had to decide what, when, and where to sell the different beverages, the amount of taxes to impose, the conditions for shipment, and so on. The repeal was made optional rather than mandated by federal law. This was meant to allow dry states to continue their fight against alcohol (ab)use. US states enacted about four thousand different laws to regulate the sector. Some maintained the ban for many years: Utah remained dry until 1959 and Mississippi—the last one—until 1966. Eighteen states imposed a monopoly on distribution and/or sales.

All over the country, the distribution and sale of alcohol must remain separate. Most states do not allow the direct sale to consumers by imposing a number of constraints. Direct sales to private buyers or retailers (e.g., restaurants, bars, wine shops) can be completely forbidden[14] or strongly limited—for example, by prohibiting shipments, allowing purchases only at the producers' facilities, imposing a maximum number of bottles a person can buy (which affects the average shipping cost), and demanding a number of complex and time-consuming bureaucratic tasks to be completed by firms.[15] Most states require an additional license to sell alcohol directly to consumers; some even require consumers to purchase a license to order alcoholic beverages. Periodic (annual or even quarterly) reports on shipments and taxes may have to be produced for each state where the producer sells directly to consumers or retailers. This means submitting up to three hundred reports per year. Producers also have to create records for each buyer to ensure they do not exceed the amounts allowed in a certain time window decided by law. Additional restrictions can include checking the buyers' identity by sending a picture of their identity card, imposing some packaging requirements, and so forth. It turns out that in many US states, it is easier for a consumer to buy a gun than to ship a bottle of good Californian wine (Colman, 2008, p. 2).

This is the so called "three-tier system" where around 90 percent of wine is sold to retailers and consumers through distributors, 50 percent of which are sold by the five largest ones. Producers sell to distributors, who sell to retailers, who sell to consumers. Obviously, the longer the chain, the higher the final price paid by consumers due to the markups added in each ring. The economic rationale for this is to ensure economic competition and to prevent monopolies caused by vertical integration, as in the eighteenth century when many bottlers imposed their products on the saloons they owned. Since the production, distribution, and sale of alcohol was in the hands of bootleggers and criminal organizations during Prohibition, a license system would have cleaned the sector up. Another reason for the adoption of regulatory controls was to enhance socioeconomic welfare by increasing controls, quality, and prices, thereby reducing abuse and its negative consequences, especially on underage drinking.

Apart from being extremely complex, with thousands of different laws in the US states, the three-tier system has a number of important drawbacks. From the point of view of consumers, it implies higher prices that can be good if it reduces alcohol abuse, but it can be bad if it pushes people to reduce quality to leave the overall budget and total quantities unchanged.[16] This can be a serious problem if low-quality products generate more harmful effects on health.[17]

From the point of view of producers, direct sales to consumers and retailers can be an important channel, especially for small wineries that do not have large portfolios of products and large economies of scale (Colman, 2008, pp. 92–93; Thornton, 2013, p. 126). Distributors often privilege large companies or even conglomerates because they can supply large quantities of cheaper products and offer all they need, from beer to wine and spirits. This is more efficient from a logistic and economic point of view, but small producers tend to be excluded, especially in those states where the distribution of alcohol is concentrated. Indeed and unfortunately, while the number of wine firms has been constantly growing, the number of distributors has been shrinking. Small producers also have a limited scale and higher production costs, so they have to charge a higher price. Bypassing the distributor can provide a substantial contribution to the firms' budget. Further, relying on a distributor does not allow full control of the marketing strategy. In fact, distributors autonomously decide the market positioning (e.g., luxury or cheap restaurants) and the promotion effort and policy, and once again, they normally put more effort into marketing for the large producers.

Whether these state and county laws pursue the social welfare of the community as a whole or rather the specific economic interests of some groups (large producers and distributors) remains an open question. However, over time the US Supreme Court has invalidated a number of local laws which regulate alcohol distribution and sale because they were not serving the public interest.

Why has such a complex and questionable system been put in place? The reason is simple: politics! Politicians want to be reelected and therefore tend to support the groups of voters which are more organized and contribute the most to parties during electoral campaigns. On the one hand, as already mentioned, the market of alcohol distribution is very profitable and concentrated. It is easier to form a powerful lobby when there are few subjects with strong interests than when there are many with weak incentives. The Wine and Spirits Wholesalers Association and large distributors like Southern Glazer's carry on their political lobbying activity by financing congressional elections on a regular basis. Yet, the anti-alcohol religious movements continue their battle to forbid—or at least minimize—alcohol consumption and abuse. An odd alliance emerged between these two groups that have very different purposes—the first reducing competition and increasing profits and the second minimizing the negative externalities of alcohol abuse—and it has managed to file a number of motions against free distribution. (See Thornton, 2013, pp. 3, 130–147, and Colman, 2008, pp. 89–99 for a detailed description of the three-tier system.)

Appendix 8.1: The Common Agricultural Policy

From the ECSC to the CAP

In the immediate postwar period the governments of European countries were aware that, to safeguard peace, economic prosperity had to be guaranteed by encouraging cooperation. The first step of the long journey undertaken by the future European Union was the creation of the European Coal and Steel Community (ECSC) in 1951. The ECSC had been proposed a year earlier in Paris in the Schuman Declaration. The treaty clearly states that the reason for its existence was to guarantee the peace of peoples through well-being and economic stability (Preamble).[18]

After more than half a century of peace it seems difficult to conceive, but the founding fathers considered the economy more as a means to guarantee peace than as the ultimate goal when the treaty was signed. The ECSC was invested with several functions aimed at ensuring the economic prosperity of member states (Article 2) by ensuring to all consumers an orderly supply at the lowest possible prices (Article 3). The intention, therefore, was that prices be as low as possible. The same treaty also established a common market by prohibiting import and export duties, quantitative restrictions on the movement of products, public subsidies and special charges, and restrictive practices (Article 4).

It was the first step toward a free and united market, though limited only to coal and steel for the time being. The proposal was so positive that the principles of a future united Europe and the intention to create a common market for goods and atomic energy were announced in an official declaration at the end of the Messina Conference in 1955. The declaration of intent was followed by the signing of the Treaty of Rome in 1957 establishing the European Economic Community (EEC; later to become the European Union, EU) and the European Atomic Energy Community (EURATOM).

The treaty establishing the EEC reaffirmed the reasons for economic progress aimed at ensuring peace and the objective of creating a single market free of customs duties and barriers to goods or persons (Article 3). This article also provided for the establishment of a common policy in the agricultural sector, which was described in detail in Title II. In the aftermath of the war, in fact, Europe was not self-sufficient in its food supply, and despite the high proportion of the population engaged in agriculture, it depended heavily on imports from the Americas. Farmers experienced hard times, and food security was uncertain.

The objectives of the future agricultural policy were (Article 39) to increase agricultural productivity by promoting technical progress, to ensure a fair standard of living for the agricultural community, to stabilize markets, to assure the availability of supplies, and to ensure that supplies reached consumers at reasonable prices. In this list of targets, producers' needs were at the top and those of consumers at the bottom. To attain the objectives, the European Community created a common organization of agricultural markets with common rules on competition (Article 40) and established a system of guaranteed minimum prices as the pivotal tool for supporting agriculture (Article 44).

The Stresa Conference of 1958 reaffirmed and outlined in more detail the principles of the CAP set out in the treaty that found the EEC. It provided for the setting of agricultural prices at an average level compared to those in force in the European Union, the creation of a single market with free circulation of agricultural products, the protection of the internal market, and the creation of an EC budget to bear all the costs associated with the application of the common policy.

First Phase: Support of the Supply

In 1962 the first Common Market Organizations (CMOs) were created for cereals, pork, poultry, eggs, fruit, vegetables, and wine. A minimum price was guaranteed to the manufacturer in exchange for which the product was withdrawn from the market at the expense of the community. At the same time the European Agricultural Guarantee and Guidance Fund was established to finance CAP expenditure, with the "Guarantee" section acting on the prices and markets of agricultural products and the "Guidance" section providing EC funding to implement structural policies.

In the 1960s, agricultural production expanded enormously, and the Europe of Six (Germany, Italy, France, Netherlands, Belgium, and Luxembourg) achieved food self-sufficiency. In 1972 measures to encourage the modernization of businesses were introduced, including early retirement for older farmers and help and training for younger ones. In 1975 a special program to help less favored and mountainous areas was launched.

Second Phase: Restrictions on the Supply

However, from the 1970s onward production surpluses grew, and public expenditure that was necessary to guarantee minimum prices, destroy surpluses, or subsidize exports to non-EU countries mushroomed. Public opinion did not tolerate this huge waste of public money aimed at supporting an ever-smaller share of the working population, especially in light of globalization that required the use of resources to face new needs and challenges.

The EC approach changed rapidly. Whereas previously it had favored the growth of the agricultural sector using a range of tools, now it was trying to restrict production to limit surpluses. The measures adopted ranged from the allocation of quotas (e.g., by country in the sugar sector in 1979 and milk in 1984 or the planting rights of vineyards) to the reduction of guaranteed minimum prices. In 1986 a co-responsibility levy for big surpluses of cereals was imposed while in 1988 a ceiling on CAP spending was fixed through "stabilizers" that set a limit on the quantities that could receive support.

In 1992, with Commissioner Ray MacSharry's reform, efforts to restrict production and to open markets intensified. Guaranteed minimum prices were reduced by 30 percent (15 percent for beef), which brought the prices of European foodstuffs close to those of the rest of the world and led to a fall in surpluses. The decrease in price support was completely compensated by the introduction of direct aid to farmers. Support was "decoupled" from production levels through the introduction of payments per hectare, thus reducing support for producers with higher yields per hectare. Therefore, support was no longer given for production but rather for producers to promote quality rather than quantity.

In its initial stages the CAP absorbed up to 80 percent of the EC budget, but over time its impact has progressively fallen to less than 50 percent to favor investments in other sectors considered to be more strategic, such as infrastructure and scientific research.

Third Phase: Quality and Liberalization (with Caps)

In the 1990s the EC responded to the growing demand for quality food and environmental protection. With the Council Regulation (EEC) No. 2092/91, the production of raw materials and organic food was regulated for the first time, while the Council Regulation (EEC) Nos. 2081/92 and 2082/92 established the protected designations of origin (PDO; protected geographical indication, or PGI; and traditional specialities guaranteed, or TSG).

The "Santer Package" (named after then-Commissioner Jacques Santer), better known as "Agenda 2000," continued and intensified the stabilization of the CAP budget, reducing further the guaranteed minimum price as direct support for farmers and thus forcing the sector toward greater market orientation. The most important innovation, however, was the creation of a second pillar—namely, rural development—to which 20 percent of the budget was allocated. While the first pillar deals with agricultural development and the market measures to support farmers' incomes as discussed above, the second pillar aims to make farms more competitive through production differentiation and through the development of new sources of income and employment while at the same time as protecting the culture, environment, and heritage of rural areas.

The 2003 CAP reform reflects the increased willingness to invest in food quality and environmental protection by introducing cross-compliance: direct payments become conditional on compliance with certain EC (eighteen regulations) and national (good agricultural practices established by each member state) standards in matters of food safety, animal welfare, plant health, environmental protection, etc.

Lastly, the CAP Reform 2014–2020 has frozen the agricultural budget until 2020 at the nominal values of 2013, with a consequent contraction of real values. To increase the competitiveness of European agriculture, greater reliance has been placed on market mechanisms starting from 2016 (apart from national exceptions) with the abolition of quotas (e.g., in the sugar, wine, and milk sectors), thus allowing European supply to adapt to trends in world demand. A further impulse is expected from measures to promote the modernization of existing companies and the creation of start-ups by young farmers.

Funds and instruments are being set up to favor insurance against damage to crops, plants, and animals while a reserve of €400 million (at 2011 prices) has been created for unpredictable and exceptional damage. If resources are going to shrink, they will have to be used more efficiently. For this reason, a part of the direct payments is conditional on following three good practices: greening practices, the diversification of production, and measures for environmental protection. Member states will have the right to adopt schemes that encourage young farmers and small- to medium-sized businesses. Rural development objectives continue to play an important role with the first and second pillars operating in closer association.

Schizophrenic Approach to Supply Regulation

The CAP is a complex and constantly evolving policy, but what is of most interest here in the context of this volume is identifying the key elements. According to theory, public intervention in the economy should aim to (1) guarantee competition between companies, (2) reduce information asymmetries and protect public health, and (3) combat externalities of production and consumption. The second objective has been pursued through a series of regulations that have introduced ever stricter quality standards and stringent classification and labeling systems for products so that from this point of view the European Union today is the safest area in the world. The creation and strengthening of PGI and PDO quality collective brands have played a fundamental role in supporting small producers[19] and finest food. Many of the measures of the second pillar aim to protect the environment by making agriculture more sustainable, now leading us to the third objective.

The policy that first favored (from 1962 to the end of the 1970s), then limited (from the introduction of quotas on sugar in 1979 to 2015), and finally liberalized (from 2016 onward) production seems schizophrenic. The production incentive policies were conceived in the 1950s when Europe was not yet self-sufficient in agriculture, even though rapid technological progress could have suggested that food security could be reached even without any kind of public subsidy. It is hard to distinguish the growth of production as a result of technological development from the contribution of the CAP, but with an enormous use of resources, it exacerbated a trend that already existed, forcing the authorities to make a sea change less than twenty years later and put a limit on surpluses and a brake on public spending. The guaranteed minimum price (higher than in the rest of the world) and the destruction of surpluses proved to be distortive policies.[20] These two instruments caused a structural excess of supply and a waste of public money and ended up subsidizing primarily the lower-level products that would probably not have been bought by consumers. It was decided, therefore, more than fifty years after the creation of the CAP to substantially reduce support for the quantities produced and to liberalize the market abolishing supply restrictions.