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Date JUNE 5, 1981

THE MONTANA LIQUOR MONOPOLY

A CASE FOR OPEN FUNDING

by

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CONTENTS

VITA	ii
ACKNOWLEDGEMENT	iii
LIST OF TABLES	vi
ABSTRACT	vii
INTRODUCTION	2

Chapter

I. A HISTORY OF LIQUOR CONTROL IN MONTANA	7
---	---

Four Centuries of Monopolies
Montana Before Prohibition
Post-Prohibition Montana
Moralistic Control was Intended
Revenue Becomes the Boss
A Shifting Emphasis
Increased Emphasis on Revenue
A New Method of Funding
Success of Montana's Liquor Control
General Fund
Summary

II. THE QUESTION OF SUCCESS	26
---------------------------------------	----

A Tough Order
Working Toward Success
Permitted Actions
Actions Taken by Liquor Division
As the 1981 Session Began
In the Eyes of the Committee
Liquor Division "Experiment" a Success
More Freedom for the 1982-83 Biennium
Plans for the 1982-83 Biennium
Summary

III.	VIEWS OF THE OPEN FUNDING CONCEPT	47
	Closest to Business-style Financing	
	Hazards of Fixed Appropriations	
	Concentrate on Agency Programs	
	Not Without Problem Areas	
	Question of Interim Control	
	Faith and Trust are Mandatory	
	Is Government Out of Its Element?	
	Government Not Designed to Make Profits	
	Profit Should Be for Private Enterprise	
	Summary	
IV.	VALUES OF OPEN FUNDING	57
	Synopsis of Study and Findings	
	Should Government Be in Business	
	Liquor Division Should Operate Like the	
	Business It Is	
	Avoid Fixed Spending Limit	
	Encourage Profit Management	
	Limited Applications	
	Government's Purpose is to Serve	
	More Purpose for Revolving and	
	Earmarked Funds	
	Profit is Permissible for Liquor	
	Division	
	Conclusions	
	Summary	
APPENDIX		72
	Selected Charts Showing Liquor Division Sales,	
	Expenses, Profits and Their Distribution	
	During Fiscal Years 1977 Through 1981	
SOURCES CONSULTED		81

LIST OF TABLES

Table 1.	Montana Liquor Division's contributions to the state general fund for fiscal years 1979 and 1980	21
Table 2.	Net profit for liquor operations for fiscal years 1978, 1979 and 1980 and projections for fiscal year 1981 . . .	28
Table 3.	Montana Liquor Division sales activity for the period from July 1977 through February 1981	30

Abstract

During these times of high inflation rates and economic slow-down, when the attention of many people is turned toward cutting the amount of money spent by government, one would think it to be political suicide to give any agency an unlimited spending authority. There is a class of government agencies for which the opposite may be true: those agencies that generate revenue which equals or exceeds their expenditures.

The 1979 Montana Legislature initiated a hallmark funding idea when it granted the state's Liquor Division the authority to spend whatever was necessary to maintain adequate liquor and wine inventories and to operate the Montana liquor monopoly. However, they also prescribed that the pricing formula had to remain as it was on January 1, 1979, and that \$13 million profit be deposited to the general fund during the biennium. Although prospects looked glum during the first fiscal year of the biennium, the situation improved during the second fiscal year. At the start of the 1981 Legislature, it looked like the liquor monopoly's profit would be about \$13.4 million. The 1981 Legislature agreed that the blanket appropriation was proper for the Liquor Division and approved it again for the 1982-83 biennium. This time the provisions were made that the profit margin and operating expenses be limited to fifteen percent of net sales (gross sales less taxes and discounts) and that the profit deposited to the general fund be at least \$13 million. Otherwise, the Liquor Division could do whatever necessary to generate the required profit.

After examining the general facts about the liquor monopoly operation during the 1980-81 biennium and listening to a discussion of the issue by several members of the joint appropriations subcommittee, the conclusion can be reached that the open funding concept is the best way to fund government agencies such as Montana's Liquor Division and that it has enough merit to be considered for other agencies that generate revenue by their operation.

INTRODUCTION

INTRODUCTION

"Government is too big! Let's reduce the size of government by cutting its budgets."

"No, government should be run like a business. That will reduce it in a more effective way."

These could be typical remarks overheard at a gathering of government critics. Is either tactic possible? Or feasible? It is difficult to say. Experts and Legislators have been trying for years to reduce the size of government. It is easy to see their lack of success. As for the tactic of running government like a business, it has rarely been tried for a profit-making agency.

The U. S. Postal Service may come to mind as a case of running government like a business. However, the U. S. Postal Service, as it currently exists, is not intended to make a profit but to be self-supporting. It is common knowledge that the U. S. Postal Service is not even doing that.

Running government like a business may not be feasible for those areas of government that primarily provide no-cost services or benefits. These include areas whose programs provide some service for the taxpayers without a direct fee or

cost, such as Montana's Department of Social and Rehabilitation Services, Department of Natural Resources and Conservation or Department of Health and Environmental Sciences. It should, however, prove quite feasible in some revenue generating areas which provide a service or product to consumers for a price. One particular operation that comes to mind is the retail sale of alcoholic beverages, as conducted by Montana and seventeen other states, to regulate the consumption of liquor.

Purpose of Study

The major objective of this professional paper is to reach a conclusion regarding the value of unlimited spending authority (referred to as open funding) and its applicability in government fiscal policy.

Should any government agency be allowed to spend as much as it wants, even one that generates a profit? This study will attempt to determine the major benefits and disadvantages of such a funding method in order to evaluate whether it applies to profit-making government agencies.

All private sector businesses are in existence to make profits. They generally establish their goals in terms of return on investment, profit margin, profit amount, profit growth, etc. Their budgets then, become the anticipated

expenditures to accomplish these goals. Their budgets are seldom rigid and inflexible, but allowed to change when there is reason. It follows that a profit-making government agency should be budgeted in a similar manner. Its goals should be established in terms of some operating or investment factor. Its budget should then be based on those goals and allowed to be flexible rather than be "cast in concrete" by the Legislature. An open form of appropriation with reference to profit margins and operating expense ratios would satisfy these requirements.

Methodology

The research method used for this study will be a case study of the Montana liquor monopoly operated by the Montana Department of Revenue, Liquor Division. The case study will be supplemented by a survey of the literature, primarily for background information.

Literature available, including documents published by the Legislative Fiscal Analyst, Department of Revenue internal study documents and recent legislation, will demonstrate a change in primary emphasis from control of liquor to the production of revenue.

Since the 1980-81 appropriation for the Liquor Division is the first known attempt at open funding for a profit-making state agency, there is no historical data on which to base an

evaluation of the funding method. An evaluation before the end of the biennium must rely on a combination of actual and estimated data and on whether the Liquor Division is seen by the 1981 Montana Legislature as having accomplished its mandated goals and is then granted continued open funding. If the Liquor Division is seen as having met its mandated goals, open funding will be considered a technical or administrative success. If the 1981 Legislature grants the Liquor Division continued open funding, open funding will be considered a political success.

The relationship between the achievement of technical or administrative success and political success will indicate the relative value of open funding as applied in this situation. If the 1981 Legislature continues the open funding concept for the Liquor Division regardless of whether success or failure is apparent for achieving the mandated goals, then it can be concluded that open funding is a politically acceptable method for funding a profit-making government agency. If open funding is not continued, even though the data indicates that the mandated goals will be met, then the conclusion should be that open funding is not a politically acceptable funding method for a government agency.

CHAPTER I

A HISTORY OF LIQUOR CONTROL IN MONTANA

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Government-operated liquor monopolies have been in existence for nearly 400 years. Generally, they had control of alcoholic beverages as their original intent. Montana's liquor monopoly is no exception. Like its predecessors, Montana's monopoly has changed its emphasis from control to revenue production. The purpose of this chapter is to briefly acquaint the reader with the history of liquor control and to summarize the shift in emphasis of Montana's liquor monopoly. A brief examination of some concerns and relationships is also included.

Four Centuries of Monopolies

According to Larry Quinn, Government-operated liquor monopolies had their beginning in the sixteenth century when the State of Russia established the first known form of liquor monopoly in 1598.¹ Although this monopoly was first established on moral grounds, it soon became an important source of revenue for the government. This monopoly system remained in effect until the twentieth century. The system

developed in 1865 in Gothenburg, Sweden, became the model for modern state owned and operated liquor monopolies.² During the middle of the nineteenth century, several New England states began systems of state-directed sales of alcoholic beverages.

Montana Before Prohibition

Before Prohibition, Montana's liquor control consisted of only a few ineffectual laws. The first laws passed under the territorial government were concerned with licensing the sales of liquor and were imposed to raise revenue. The license fees were set at \$30.00 per quarter for the sale of liquor within two miles of any town and \$8.00 per quarter for the sale of liquor outside that limit.³

Later laws were concerned with the protection of individuals hurt by intoxicated persons, primarily the wives and children of drunkards.⁴ For example, the sale of liquor within one mile of any religious camp meeting was considered an "Offence Against the Public Peace and Tranquility."⁵ Some further examples are:

A fine of \$200 was demanded from anyone found guilty of adulterating ('watering', diluting or otherwise making less valuable) liquor for sale.

Anyone giving or selling liquor to any United States troops could be imprisoned for one year and fined \$500; and,

Anyone giving or selling liquor to Indians or half-breeds could be fined \$500 and sent to prison

for a maximum of three years.⁶

The Eighteenth Amendment to the Constitution of the United States made all those laws worthless. Montana bowed out of enforcing the Eighteenth Amendment when its citizens voted in 1926 (83,231 to 72,982) to abolish all state Prohibition laws.⁷ This action left the task of trying to enforce the prohibition to the Federal government.

When the Twenty-first Amendment came on the scene in 1933, Montana was among twenty-three states that were waiting in anticipation of ratification. Liquor once more became a legal commodity in Montana when the Twenty-first Amendment was ratified in December of that same year.⁸

Post-Prohibition Montana

The return of liquor to Montana was not a partisan issue: both parties supported bills concerning liquor's return. In the 1933 session, L. P. Donovan (Dem., Toole) and Thomas J. Walker (Dem., Silver Bow) introduced Senate Bill 153 to authorize the manufacture and sale of liquor under state regulation and licensing. The bill passed the Senate by a vote of thirty-two to fourteen and the House by a vote of seventy-one to nine.⁹ The 1933 Montana Legislature also passed two companion bills: to call for a statewide convention to decide on the adoption of the Twenty-first Amendment to the

Constitution of the United States, and to establish regulations for the sale of beer.

However, the return of liquor to Montana was not unopposed. Memories of the "evil" saloon persisted, causing objections to be raised. The Anti-Saloon League stated that it would be "unrelenting in demanding government ownership, manufacture and sale at cost plus tax."¹⁰

Rather than attempting to control liquor with licensing, the Montana Legislature decided to obtain the greatest possible control over liquor by copying the monopoly system used in Alberta, Canada.¹¹

The New York State Moreland Commission report outlined four basic purposes of alcoholic beverage control systems:

- 1) to prevent crime, political corruption, and immorality resulting from prohibition;
- 2) to provide a source of revenue for state and local governments;
- 3) to establish controls over the alcoholic beverage industry, especially retail sales; and
- 4) to promote temperance in the use of alcohol.¹²

Each of these points was referenced in the Montana law. However, the fourth point was the most important because without it there remained "no understandable reason for the existence of any such law or for the rules and machinery developed for its activation."¹³ But, since it is impossible to absolutely control the amount of alcohol that individuals

drink, behavior could not be directly controlled. Therefore, the Montana Legislature undertook a middle course and promulgated a law which could influence behavior, but could not control it with any certainty. *W. H. Hagerman*

Moralistic Control was Intended

There are indications that the Montana Legislature intended primarily to control alcohol use, rather than generate revenue. It was the declared policy of the State of Montana to "effectuate and insure the entire control of the manufacture, sale and distribution of liquor within the State of Montana."¹⁴ The intention to control was also indicated in that the acts were to be "deemed an exercise of the police power of the state, in, and for the protection of, the welfare, health, peace, morals and safety of the people of the state and their provisions shall be construed for the accomplishment of such purposes."¹⁵

These intentions are further reinforced by subsequent court decisions. In *State v. Andre* (101 M 366, 371, 54 P 2d 566) it was decided that the State Liquor Control Act of Montana, regulating the sale of intoxicating liquors and providing for a system of state stores for their sale and distribution is an exercise of a governmental function within the police power of the state. The decision in *State v. Driscoll* (101 M 348, 365, 54

P 2d 566) further reinforced the moralist intentions by showing that the State Liquor Control Act of Montana, whose main purpose is to regulate the manufacture and sale of alcoholic beverages, but which incidentally results in profits from the operation of State liquor stores, does not violate Section 32, Article V of the Montana Constitution, which provides that bills for raising revenue must originate in the House.

In order to strengthen the control of alcoholic beverage use, the law provided for the prohibition of the sale of alcohol, through an interdiction process, to any person who "by excessive drinking of liquor, misspends, wastes, or lessens his estate, or injures his health, or endangers or interrupts the peace and happiness of his family."¹⁶ This put the responsibility on the courts to effectuate the process for preventing alcohol abuse from ruining the homes it was expected to ruin if it was not controlled.

The part of the law providing the regulations for the distribution of alcoholic beverages also demonstrated the moralistic intentions of the control act by specifying that licensees or their employees shall not sell or give away any alcoholic beverages to:

1. Any person under the age of twenty-one (21) years.
2. Any intoxicated person or any person actually, apparently or obviously intoxicated.
3. A habitual drunkard.
4. An interdicted person.¹⁷

These are but a few examples of portions of the Liquor Control Act of Montana, but they clearly show the intent of the Montana Legislature in establishing the monopoly system of liquor control in Montana.

Revenue Becomes the Boss

It is frequently said that "History repeats itself." Liquor control in Montana has not been an exception. It has followed the pattern set by Russia in that the idea of moral protection has given way to the production of revenue.¹⁸

A Shifting Emphasis

The shift in emphasis from a moralistic attempt to protect the people from the evils of alcohol and its abuse to a primary concern with raising revenue has been gradual and is not yet complete. As recently as 1977 the Montana Legislature passed acts amending the Montana Alcoholic Beverage Code in a moralistic fashion. The amendments increased the license tax on liquor from five percent to ten percent of the retail price and directed that the revenue derived from the license tax be distributed to the cities and counties where the liquor is consumed and to the Department of Institutions. These funds are to be used specifically "for the treatment, rehabilitation and prevention of alcoholism."¹⁹ The section referring to the

license tax on beer was also amended, raising the tax from \$.25 to \$1.00 per 31-gallon barrel.²⁰ This tax on beer is for the same purposes as that on liquor.

An indication that the intended control is not completely effective is the continued increase in liquor consumption with little corresponding rise in Montana's population. The apparent consumption (based on sales rather than what is actually drunk, which is unknown) of distilled spirits rose from 1.1 million gallons in 1970 to 2.0 million gallons in 1980, an eighty-two percent increase. During that same period, the population of Montana increased from 694,409 to 786,690, an increase of thirteen percent.²¹ Sales by the State liquor monopoly have recently been growing at an average rate of four to five percent each year with virtually no increase in the number of retail licensees (because of the quota system established in 1947 which included a grandfather clause allowing earlier issued licenses to be kept, even though they were in excess of the quota).²² This would lead one to believe that, if people want to drink alcoholic beverages, they will not be stopped by a little inconvenience in acquiring the beverage. The profusion of bootlegging operations during national prohibition confirms this.

Evidence pointing to revenue replacing moral protection as the primary purpose of the State's liquor monopoly system is

not as abounding as that for the moralistic intent, but does exist nonetheless.

A recent study conducted by the Legislative Fiscal Analyst's office was under legislative mandate to "explore alternatives to the present marketing structure that would 'assure no reduction' from the presently realized revenues."²³ This clearly demonstrates higher consideration for the revenue produced by the state's liquor operation than for the meager improvement it brings to the citizens' morals. The overall tone of the report leads one to believe that also. Of a list of twenty findings of the study, only the last finding even mentions alcohol abuse:

The rate of alcohol abuse may be marginally increased if liquor and wine sales were decontrolled. However, such a minimal increase likely could be more than offset by altering the drinking age and marketing structure on Indian reservations.²⁴

Such an attitude can only imply that the revenue is more important than the control or prevention of alcohol abuse.

A task force impaneled in 1977 to develop or document the goals and objectives of the Montana Department of Revenue, Liquor Division (hereafter referred to as Liquor Division) defined the overall, general goal: "to optimize the production of revenue from liquor operations within the constraints of control, service, and the law."²⁵ In further defining the goals of the overall monopoly system, the task force determined

that the goal of the merchandising/marketing function was to provide attractive stores that were convenient for the consumers and carried mostly what the consumers wanted.²⁶

It stands to reason that, if you want to control (limit) the consumption of any commodity, for any reason, you should make procurement less convenient. The aforementioned goal of providing stores convenient for the consumers runs contrary to a temperance philosophy of limiting the consumption of alcohol by individuals. Thus, the original intent of protection from alcoholism is nullified and the only possible intent remaining is to raise revenue.

Increased Emphasis on Revenue

Initiative 81, approved by the voters in November 1978, provided that table wines would be available for sale in grocery and drug stores and would no longer be sold by the State liquor monopoly after June 30, 1979. The initiative also changed the tax on table wines to a rate of \$.75 per gallon volume. The tax had previously been the same as distilled spirits: 26% of the retail price. The 1979 Montana Legislature, after lengthy debate, passed Senate Bill 99 amending the provisions of Initiative 81 to allow the State to continue to sell table wines and to set the tax on table wines at \$.20 per liter volume (a close approximation to \$.75 per gallon).²⁷

House Bill 844, passed in the same session, changed the proportions of distribution for the liquor license tax. The tax collected on table wine sold other than at State stores was to be distributed 80% to the General Fund and the rest shared equally by the cities, counties and the Department of Institutions. The license tax on distilled spirits (still sold only through State stores) was to be distributed as follows: 30% to the cities and towns, proportionate to their sales; $4\frac{1}{2}\%$ to the counties, proportionate to their sales; and the remaining $65\frac{1}{2}\%$ to the Department of Institutions. These tax revenues were still to be used for the treatment, rehabilitation and prevention of alcoholism.²⁸

A New Method of Funding

The 1979 Legislature also made a dramatic departure from the norm in House Bill 483, its appropriation measure for the State's Liquor Division. The Legislature in effect said: "Spend what you need; just be sure to rake in \$13 million profit in the next two years."²⁹ Under the language of the act, the liquor stores could be more flexible with their hours, stores could be closed or converted to agencies, or new stores could be opened. Essentially, the Liquor Division could do whatever was necessary to ensure the earning of the \$13 million profit. The only requirement was that the pricing structure (the

formula for deriving prices) could not be changed except to comply with the change in tax computation methods for table wines.³⁰

Success of Montana's Liquor Control

How can the importance of Montana's liquor monopoly be determined? One way is to evaluate its contribution to the public welfare. The two main goals of Montana's monopoly, control and revenue production, are chosen for a brief analysis. The success of the intention to control will be considered briefly here. The next chapter will deal with success in raising revenue and success as it relates to the government budgeting process.

As implied above, control is the limiting of alcoholic beverage consumption to such an extent as to eliminate or, at least, minimize the problems of alcoholism. A direct measurement of the limiting of alcoholic beverage consumption is not possible. An indirect indicator is per capita consumption. According to the Distilled Spirits Council of the United States, the per capita consumption of distilled spirits in Montana was 2.10 gallons in 1977 and 2.07 gallons in 1978. These consumption amounts ranked twenty-seventh lowest and twenty-fourth lowest among all states for 1977 and 1978, respectively. Among the eighteen control states,³¹ Montana

ranked fourteenth lowest and thirteenth lowest, respectively, for the two years.³² Compare these rankings with forty-fifth lowest among all states and twelfth lowest among control states at the start of the decade.³³ These rankings show that, although Montana is not doing a particularly good job of limiting consumption, it is improving relative to the rest of the states. The improvement comes in spite of the increasing emphasis on revenue production during the middle 1970's. Since the total consumption increased by twelve thousand gallons from 1977 to 1978, the slight decrease in per capita consumption suggests that the alcoholic beverage control has been marginally successful in Montana, assuming that the proportion of alcohol consumers in the added population was the same as that for the old population. If, however, the ratio of alcohol consumers to non-consumers was lower in the new population, the reverse would be suggested. Since data is not available on the ratios of alcohol consumers to non-consumers, we must regard the above data as being somewhat inconclusive.

General Fund

As large as \$13 million seems to us, it is not that great when considered in proportion to the total revenue transmitted to the state general fund in Montana. The total revenue transmitted to the state general fund by the Liquor Division

amounted to 6.6 percent of the total general fund in fiscal year 1979 and 5.6 percent in fiscal year 1980 (See Table 1).

Summary

This chapter has been a brief historical summary of liquor monopolies and an overview of some of the indications of the shifting emphasis from control to revenue through 1979. The legislatively mandated study conducted by the Legislative Fiscal Analyst's office, the Department of Revenue internal study and the blanket appropriation granted by the 1979 Legislature are all indications of the shift. Events since the 1979 Montana Legislature are examined in detail in subsequent chapters.

Table 1.--Montana Liquor Division's contributions to the state general fund for fiscal years 1979 and 1980

	Funds Transmitted (000's)	
	<u>Fiscal year 1979</u>	<u>Fiscal year 1980</u>
Liquor Tax	\$ 7,022	\$ 5,765
Beer Tax	1,202	1,217
Wine Tax		1,312
Retail Profits	7,200	5,500
Total Transmitted	\$ 15,424	\$ 13,795
Total General Fund	\$ 233,360	\$ 248,132
Liquor's percent of Total	6.6	5.6

Note: Wine tax is included with liquor tax prior to fiscal year 1980.

Source: Statewide Budgeting and Accounting System (SBAS) revenue collection reports.

Footnotes

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2. August F. Fehlandt, A Century of Drink Reform in the United States (Cincinnati, Ohio, 1904), p. 66; E. H. Cherrington (ed.) Standard Encyclopedia of the Alcohol Problem (Westerville, Ohio, 1925), III, 1122; as cited by Quinn, Politicians in Business, p. 2.
3. Acts Resolutions and Memorials of the Territory of Montana, Passed by the Fourth Legislative Assembly Convened At Virginia City, November 4, 1867 (Virginia City, Montana, 1869), p. 237, as cited by Quinn, Politicians in Business, p. 3.
4. Quinn, Politicians in Business, p. 3.
5. Laws Memorials, and Resolutions of the Territory of Montana, Passed at the Seventh Session of the Legislative Assembly, Begun at Virginia City, December 4, 1871, And Concluded January 12, 1872 (Deer Lodge, Montana, 1872), pp. 300-301, as cited by Quinn, Politicians in Business, p. 3.
6. Ibid., pp. 303, 305, as cited by Quinn, Politicians in Business, p. 3.
7. Quinn, Politicians in Business, p. 4.
8. Ibid.
9. Senate Journal of the Twenty-third Legislative Assembly of the State of Montana Held at Helena, the Seat of Government of Said State, Commencing January 2nd, 1933 and Ending March 2nd, 1933 (Helena, Montana, 1933), p. 582; House Journal of the Twenty-third Legislative Assembly of the State of Montana Held at Helena, the Seat of Government of Said State, Commencing January 2nd, 1933 and Ending March 2nd, 1933 (Helena, Montana, 1933), p. 730; as cited by Quinn, Politicians in Business, p. 4.
10. "The Daily Missoulian", December 3, 1932, as cited by Quinn, Politicians in Business, p. 4.
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- Law, Study Paper Number 1, The Relationship of the Alcoholic Beverage Control Law and the Problems of Alcohol, October 18, 1963 (New York, 1963), p. 1, as cited by Quinn, Politicians in Business, p. 6.
13. Ibid.
 14. Title 4, Chapter 1, Section 4-101, Revised Codes of Montana, 1947, as amended by the Legislatures of 1949 through 1967, inclusive.
 15. Ibid.
 16. Title 4, Chapter 2, Section 4-201, Revised Codes of Montana, 1947, as amended by the Legislatures of 1949 through 1967, inclusive.
 17. Title 4, Chapter 4, Section 4-413, Revised Codes of Montana, 1947, as amended by the Legislatures of 1949 through 1967, inclusive.
 18. Quinn, Politicians in Business, p. 1.
 19. Title 4, Chapter 1, Section 4-1-401, Revised Codes of Montana, 1947, as amended by the Legislatures of 1949 through 1977, inclusive.
 20. Title 4, Chapter 1, Section 4-1-404, Revised Codes of Montana, 1947, as amended by the Legislatures of 1949 through 1977, inclusive.
 21. Distilled Spirits Council of the United States (DISCUS), Annual Statistical Review 1978 (Washington, D.C., 1980), p. 42, supplemented with data from Montana Department of Revenue, Liquor Division operating reports for 1979 and 1980. Population figures are from United States Census Bureau reports for 1970 and 1980.
 22. Interview with Thomas J. Mulholland, Assistant Administrator, Montana Department of Revenue, Liquor Division, Helena, Montana, March 5, 1979.
 23. Office of the Legislative Fiscal Analyst, Fiscal Impacts of Altering Montana's Liquor Distribution System (Helena, Montana, 1976), p. 5.
 24. Ibid., p. 4.
 25. Department of Revenue Liquor Policy Statements and System Goals and Objectives Task Force Report, May 10, 1977 (Helena, Montana, 1977), p. 1.

26. Ibid., p. 8.
27. 46th Legislature of the State of Montana, Senate Bill 99.
28. 46th Legislature of the State of Montana, House Bill 844.
29. The Great Falls Tribune, May 20, 1979.
30. 46th Legislature of the State of Montana, House Bill 483.
31. The term "control states" refers to those states engaging in a state-run liquor monopoly, for either retail, wholesale or both levels of sales, for the purpose of alcoholic beverage control. The remaining states effect control over alcoholic beverages through various systems of licensing.
32. DISCUS, Annual Statistical Review 1978, p. 40.
33. Montana Liquor Control Board, Annual Report of the Montana Liquor Control Board, 1970 - 1971 (Helena, Montana, 1971), p. 8.

CHAPTER II

THE QUESTION OF SUCCESS

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THE QUESTION OF SUCCESS

Before we can begin to answer the question implied by this chapter's title, we must define what we mean by success. We are discussing a method of funding for a class of government agencies. Therefore, it is fitting that we adopt a basic definition of success used by many executive branch agencies. Success, to them, means accomplishing what the last legislature mandated in such a way that the next legislature approves their budget request. It is easily conceivable that an agency could achieve legislatively mandated goals, but, in so doing, arouse hostilities and thereby incur the wrath of the Legislature. The most likely result would then be severe problems in getting the next budget approved. Deep budget cuts or even agency elimination could be the result. By the above definition, indications are that Montana's Liquor Division will be successful for the 1981 biennium.

The determination of success will be based on two factors:

- 1) Will the Liquor Division achieve its legislatively mandated goal of \$13 million profit without sacrificing effectiveness of liquor control?
- 2) Will the Liquor Division be allowed to

continue operating in the same manner--like a private sector business?

A Tough Order

If there had been no changes in the liquor laws, then projecting a sales trend to create \$13 million in profits would appear to have been quite reasonable (See Table 2). However, the voters had approved two measures affecting the state's liquor monopoly in the November 1978 elections. The first, Initiative 81, was intended to take table wine out of the state liquor stores and put it in grocery and drug stores. The second changed the legal minimum drinking age from eighteen to nineteen years.

The proponents of Initiative 81 contended that there would be no loss of revenue to the state by removing the sale of table wine from the state stores. They held that sales would increase approximately 400 percent, as in Idaho when table wines were taken away from their state stores and permitted in grocery and drug stores. This, they said, would provide the same amount of tax revenue. Not one word was uttered, however, about replacing lost profits. A study by the Department of Revenue, Research Division, showed that a sales increase of nearly 600 percent would be necessary to offset the total revenue loss to the state. It was strongly rumored that the

Table 2.--Net profit for liquor operations for fiscal years 1978, 1979 and 1980 and projections for fiscal year 1981

	FY 78	FY 79	FY 80	FY 81
Gross Sales: Liquor	\$ 51,280,983	\$ 55,207,711	\$ 48,056,110	\$ 53,064,630
Less Discounts	1,038,636	1,142,279	913,407	1,061,292
	50,242,347	54,065,432	47,142,703	52,003,338
Less Cost of Goods Sold	28,347,315	30,547,705	27,323,770	29,371,272
Gross Profit: Liquor	21,895,032	23,517,727	19,818,933	22,632,066
Plus Other Income	6,000	6,000	6,000	6,000
Gross Profit: Merchandise	21,901,032	23,523,727	19,824,933	22,638,066
Less: Taxes	10,581,790	11,392,067	9,547,968	10,346,568
Operating Expenses	4,962,000	5,442,000	5,584,227	6,429,370
Net Profit	\$ 6,357,242	\$ 6,689,660	\$ 4,692,738	\$ 5,862,128

Source: Compiled from Liquor Division operating reports and revenue estimates prepared by the Research and Information Division of the Department of Revenue.

Liquor Division was very skeptical of the 400 percent figure and knew that the higher figure would be unattainable.

The profits generated by the Montana Liquor Division, being a fixed percentage of the price of each item, generally follow trends of gross receipts. In examining the gross sales for fiscal years 1978 through 1980 and the first months of fiscal year 1981 (See Table 3), one can see that sales are increasing from year to year for the same month until fiscal year 1980, when a marked decrease is seen. The figures for the first months of fiscal year 1981 show a definite improvement over fiscal year 1980 and sometimes exceed those for fiscal year 1979. Examining the gallons sold for the same period, the marked decrease in gallons sold during fiscal year 1980 is quite evident (See Table 3). This suggests that the decrease in gross sales dollars is due more to decreasing sales and less to the reduced taxes on table wines. The gross sales for the first twenty months of the 1980-81 biennium are approximately ninety-five percent of the sales during the first twenty months of the 1978-79 biennium. If this trend holds for the remainder of the 1980-81 biennium, it appears that the Montana Liquor Division will only generate about \$12.39 million in profits. If they can make a substantial reduction in operating expenses, they might make the profit requirement.

Table 3.--Montana Liquor Division sales activity for the period beginning July 1977 and ending February 1981

a. Gross Sales in Thousands

	<u>FY 78</u>	<u>FY 79</u>	<u>FY 80</u>	<u>FY 81</u>
July	\$ 3,729	\$ 4,389	\$ 3,682	\$ 4,433
August	4,057	4,692	4,205	4,587
September	4,071	4,350	3,739	4,008
October	4,032	4,336	4,196	4,661
November	4,678	5,025	4,242	4,453
December	7,447	7,833	6,420	7,491
January	3,091	3,478	3,324	3,594
February	3,481	3,723	3,468	3,593
March	4,275	4,578	3,694	
April	3,873	4,030	3,273	
May	4,115	4,186	4,121	
June	4,432	4,587	3,692	
Totals	\$ 51,281	\$ 55,207	\$ 48,056	?

b. Sales in Gallons

	<u>FY 78</u>	<u>FY 79</u>	<u>FY 80</u>	<u>FY 81</u>
July	184,927	201,987	150,301	161,179
August	201,139	219,127	167,735	163,703
September	197,011	204,598	146,978	142,165
October	193,623	202,080	159,987	162,955
November	230,396	236,362	163,905	155,784
December	353,615	355,065	238,719	256,513
January	150,664	162,904	123,361	124,792
February	169,351	177,689	132,592	124,340
March	208,467	213,948	139,658	
April	186,172	188,856	137,830	
May	196,995	197,589	155,405	
June	209,723	208,623	135,720	
Totals	2,482,083	2,568,828	1,852,191	?

Source: Liquor Division operating reports.

As for the change in minimum legal drinking age, it is virtually impossible to estimate the impact of a change of this type. Data is not available on alcoholic beverage consumption according to age groups.

Working Toward Success

The action by the 1979 Montana Legislature in passing House Bill 483 is surely a keystone innovation in appropriation legislation. For once an agency administrator could do what many people had said he should be doing: run his agency like a business. If any agency should be the guinea pig in this kind of an experiment in Montana, it is rightly the Liquor Division. The Liquor Division can easily be envisioned as a large corporation with the taxpayers of the state as its stockholders.

Prior to the 1980-81 biennium, the Liquor Division had been funded by fixed appropriation through a revolving fund. While the appropriations subcommittee was wrestling with the Liquor Division's 1980-81 budget request, the Liquor Division Administrator suggested that, if he were allowed to run the division like a business, to take advantage of some modern marketing techniques and new technology, he was confident that approximately the same amount of revenue could be generated. The subcommittee was apparently convinced enough to recommend

the blanket spending authority with the profit requirement and the provision that the pricing formula remain unchanged.

Permitted Actions

Under House Bill 483, the Liquor Division was charged with the responsibility for operating the state liquor monopoly in such a manner as to generate at least \$13 million in profits for deposit to the general fund. The division was given full authority to determine store operating hours and the numbers and locations of liquor store employees and stores.

There was one restriction other than the mandated profit requirement. The pricing formula in effect on January 1, 1979, was to remain unchanged.

This appropriation measure also included some guidance concerning legislative intent. It was stated that unprofitable state stores should be closed or converted to agency stores in an orderly manner.¹ An unprofitable store was defined as one that showed a net loss, or was less profitable than if run as an agency store.²

Actions Taken by Liquor Division

The Liquor Division could hardly wait for the new biennium to start making some changes. The Division had been wanting for some time to convert several unprofitable and marginal

state stores to agency stores and to make other changes to its operation for improved efficiency. Now, with the guidance and stated intentions contained in House Bill 483, the division had something with which to overcome the expected objections of the store clerks' union.³ No union should be expected to remain silent as its members face losing their jobs because of an administrative policy such as this one concerning state store to agency conversion.

Under the flexibility of open funding, a variety of actions were taken. The greatest activity was evident in the Stores Bureau, which has the responsibility for operating the state stores and overseeing the agency stores. During fiscal year 1980, there were twenty-seven state stores converted to agency stores, two new agency stores opened, two agency stores closed and four agency stores moved to new locations or agents. Primarily through these store changes, the division was able to reduce overall staffing by forty-two positions. This reduction in staffing created a sizeable reduction in operating expenses, thereby assisting towards realization of the mandated profit requirement. In addition, one new state store has been opened and four others have been moved to new locations. Another thirty-one state stores were remodeled and/or had their sales areas rearranged. The conversions to agency status eliminated the losses due to unprofitable

operation at those locations. The other changes were intended to make the state stores more convenient and attractive for their customers. As of the end of fiscal year 1980, the retail operation of the Montana liquor monopoly consisted of eighty-one state stores, sixty-two agency stores and one cash basis store (Malmstrom A.F.B.).⁴ Activities during the first half of fiscal year 1981 occurred at a somewhat slower rate. As of December 31, 1980, there were seventy-seven state stores, sixty-six agency stores and the one cash basis store.⁵

The Stores Bureau has also instituted some new programs to improve the quality of personnel and has begun a bonus incentive program for state store employees. Several of the store managers have attended a seminar on creative management techniques. More are scheduled to attend the seminar during fiscal year 1981 and the rest should have attended by the end of the 1982-83 biennium. The bonus plan consists of a one-time bonus of five percent of gross salary for all full-time employees of stores that increase their productivity by ten percent. Productivity is the number of units(bottles) sold per manhour actually worked. It is measured for each quarter and compared with the same period from the prior year. The rules allow the stores to either reduce manhours worked or increase sales, or any combination. Of course, manhours worked can only be reduced a limited amount before sales begin to suffer.⁶

The division has placed wine coolers in two of the larger stores. They have been received well by the public and more are planned for the future.⁷

During fiscal year 1980, the Liquor Division began offering periodic specials at reduced prices. These specials are passing on the temporary price reductions given to the state by the distilleries and wineries. They also serve to attract customers for other possible purchases.⁸

As the 1981 Session Began

The 1979 Legislature rightly recognized that it would take some time after changes were implemented before the effects could be realized. They properly did not require the \$13 million to be deposited to the general fund in two equal installments. Therefore, the Liquor Division deposited \$5.5 million in fiscal year 1980 of the actual \$6.2 million profit. This allowed them to use the \$0.7 million as operating capital during fiscal year 1981.⁹

Comparing the sales data for the first six months of fiscal years 1980 and 1981, then extending the proportions to project the balance of fiscal year 1981 results in an estimate of \$52.7 million gross sales (net of discounts). Using known expense figures and projected taxes, the profit for fiscal year 1981 is estimated to be \$7.2 million. When added to the

generated profit for fiscal year 1980, the total profit generated for the 1981 biennium is \$13.4 million. The Liquor Division appears to have made their goal with room to spare.¹⁰

In the Eyes of the Committee

All of the estimates and projections indicating success are to no avail unless they are accepted by those who hold the purse-strings. In this case it is the Montana Legislature. The Legislative Fiscal Analyst's office examines the budget requests and past performance of the executive branch agencies then makes recommendations to the appropriations subcommittees. Many times these recommendations can make or break an agency.

Liquor Division "Experiment" a Success

As discussed above, present information indicates that the Liquor Division will succeed for the 1980-81 biennium, at least as far as the legislative mandate is concerned. The division's success in meeting the test of continued legislative support was answered by the 1981 Montana Legislature and the Legislative Fiscal Analyst's budget analyst assigned to the Liquor Division.

In preparing for the 1979 Legislature, the budget analyst had attempted to use computer modeling techniques to determine

the sales and expenses that would be affected by Initiative 81. It was found during the modeling process that only the variable expenses could be reduced to help offset the revenue reduction from the sales decrease. They were not proportionate to the decrease in sales. These findings prompted the budget analyst to recommend a substantial reduction in the authorized staffing level for the division. The analyst also recommended that many of the smaller state stores be converted to agency stores.¹¹

For the 1981 Legislature, the budget analyst concurred with the projections that the Liquor Division would, indeed, meet its mandated profit goal.¹² This was done in spite of the loss of table wine and 18-year-old's sales being compounded by a generally fiscally depressed fiscal year 1980. Fiscal year 1981 is reversing that trend, but still has some catching up to do. The fiscal depression was the result of a general economic depression. It could also be seen in other revenue areas, such as auto licenses, income tax, property tax, etc.¹³ By meeting the goals set for his division in the face of such odds, the Liquor Division Administrator demonstrated that he was worthy of the faith and trust the Legislature must have in him as a manager. This faith and trust is necessary if the Liquor Division is to be allowed to continue operating as a business.

More Freedom for the 1982-83 Biennium

The question before the 1981 Legislature was: Can this act be repeated, or, perhaps even be improved upon? The only way to find an answer was to give the division a little more free rein and see what happens.¹⁴ Such was the consensus of the appropriation subcommittee. They recommended that the Liquor Division again be given blanket spending authority. This time there are no real restrictions on what the Liquor Division can do. The language in the appropriation measure, House Bill 500, is that funds are appropriated "as necessary to maintain adequate inventories of liquor and wine and to operate the state liquor monopoly." The provisos in the bill are that the profits deposited to the general fund be at least fifteen percent of net sales (gross sales less taxes and discounts) but not less than \$13 million and that operating expenses not be greater than fifteen percent of net sales.¹⁵ These profit margin and operating expense proportions are approximately what occurred during the 1980-81 biennium. Therefore, they do not represent any real limitation.

Plans for the 1982-83 Biennium

A great deal was accomplished during the 1980-81 biennium leading towards higher profitability. More remains that can be done. The Liquor Division would like to open four new stores to

handle increased sales potential. Two of these new stores are proposed for Billings, one is proposed for Missoula and one is proposed for Helena. Billings, Montana's largest city, presently has three stores. For comparison, Montana's second largest city, Great Falls, has three stores plus one at adjoining Malmstrom Air Force Base. Missoula is the fourth largest city and is growing rather rapidly. Two liquor stores are presently located there. Helena, the capitol city, has only one liquor store and has grown large enough that a second store is needed to serve the public better and with more convenience.¹⁶

More of the existing stores are expected to be remodeled and rearranged to make them more attractive and make it easier for the customers to find what they want. In the past, the merchandise displays have been arranged according to the Montana product code numbers. When the codes were originally devised, the numbers were grouped according to liquor type. That is, the whiskeys, gins, vodkas, brandies, wines, etc., were each given a discrete, contiguous group of numbers. Since then, with the addition and deletion of products, that discrete grouping no longer exists. The major function of the display rearranging is to group the products again by liquor type. In the rearranging process, the items are also being assigned an amount of shelf space relative to their sales ranking. A side

benefit to the rearrangement is that it helps to simplify and speed up the processes of restocking and taking inventory.¹⁷

During the 1980-81 biennium, wine coolers were installed in the Helena store and in one of the Billings stores to test public reaction to them. There has been a good amount of interest in the chilled wines. Stores not having the coolers have been getting queries like "Where is your chilled wine?" and "When are you getting a wine cooler?" On the basis of this response, wine coolers are expected to be installed in fifteen or twenty more stores during the 1982-83 biennium.¹⁸

There has been enough increase in the quality and efficiency of store management to more than justify the cost of the management training seminars. Therefore, the Liquor Division intends to have all of the managers who have not already done so, attend the seminars on creative management techniques.¹⁹

The Liquor Division Administration has two new activities in mind that it would like to try during the 1982-83 biennium. The first is to add one or two hundred special and vintage wines to the current selection. These special wines would be kept in the central warehouse and a listing would be distributed statewide through the stores and agencies. The special wines would be available on order within two or three weeks. The outlets would be permitted to order these special wines by the

individual bottle, rather than by case lot only as the present policy dicatates. The second activity is to begin holding wine tastings. A bit of legal clarification is necessary before this can be started. State laws prohibit the consumption of liquor in state buildings. When Initiative 81 tried to take wine out of the state stores, it also changed the definition of liquor to exclude table wines (wines containing fourteen percent or less alcohol by volume). If the checking shows that it is now legal to drink wine in state buildings, then the wine tastings will probably be tried.²⁰

Some improvements in inventory control are planned for the coming biennium. Improvement in this area has been needed for a long time. Past audits have reported excess liquor inventories. At the present time, the statewide inventory is approximately thirty to forty percent greater than necessary. With the inventory value running in the neighborhood of \$20 million, that represents a lot of money tied up in surplus inventory. A new computerized management information system is currently in the design stage of development. It is expected to be completed late in fiscal year 1982. Among its features will be a statistical forecasting technique for predicting sales for ordering purposes and possible automatic store inventory replenishment. Increasing accuracy in sales forecasting will permit lower safety inventory without

jeopardizing the high service level being attained now. Data entry and retrieval will be made more rapid through computer terminals located in the Liquor Division office. This will keep the data more up-to-date and will allow inventory questions to be answered immediately instead of in a day or two. The new system is being designed to permit the use of point-of-sale cash registers/terminals for store inventory record keeping and sales recording. It is desired for the sales data to be captured from the point-of-sale terminals at night from the central office in Helena. These developments should help a lot toward reducing the amount of surplus inventory.²¹

Summary

In this chapter we have looked at the prospects that the Liquor Division had early in the biennium for meeting its goal. We noted that the outlook was a bit dim early in the period. However, the prospect took a turn for the better during fiscal year 1981. The actions taken seemed to be working and the economic slump appeared to be getting less severe. Projections of meeting the mandated profit requirement were convincing enough for the 1981 appropriations subcommittee. They recommended a second biennium with blanket spending authority and even more freedom of action for the Liquor Division. Also

briefly discussed were some plans for the 1983 biennium to attract more sales and to reduce expenses and inventory investment.

Footnotes

1. An agency store is an outlet that is operated by an agent who is not a state employee, usually in conjunction with another business such as a grocery or drug store. Most agency stores are located in small towns that would not support a state operated store. Liquor is shipped to the agency stores on an informal consignment basis. The total amount of the liquor sales is deposited to the State Treasury and, when the month's sales has been computed, the agent is sent a check for the ten percent commission, based on gross sales less discounts.
2. 46th Legislature of the State of Montana, House Bill 483.
3. Interview with Leon J. Messerly, Administrator, Montana Department of Revenue, Liquor Division, Helena, Montana, April 16, 1981.
4. A cash basis store is one that pays for each shipment when it is received and is always considered as having a zero inventory. Since all shipments are on a case lot basis, the cash store's sales are all subject to the five percent case discount, which is deducted from the amount remitted. The one cash basis store at Malmstrom A.F.B. also is permitted to deduct an amount equal to its ten percent agency commission. This arrangement is permitted because the store is on Federal property and is thus not required to abide by the state liquor laws. Malmstrom A.F.B. buys its liquor from the Montana monopoly for convenience and as a courtesy to Montana.
5. Interview with Leon J. Messerly, April 16, 1981.
6. Ibid.
7. Ibid.
8. Ibid.
9. Ibid.
10. Ibid.
11. Interview with JanDee May, Budget Analyst, Office of the Legislative Fiscal Analyst, Helena, Montana, April 8, 1981.
12. Ibid.
13. Ibid.

14. Interview with State Representative John M. Shontz (Dem., Dist. 53, Richland County), Helena, Montana, April 7, 1981.
15. 47th Legislature of the State of Montana, House Bill 500.
16. Interview with Leon J. Messerly, April 16, 1981.
17. Ibid.
18. Ibid.
19. Ibid.
20. Ibid.
21. Ibid.

CHAPTER III

VIEWS OF THE OPEN FUNDING CONCEPT

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Whether you call it blank check, open funding or blanket spending authority, the concept of allowing a state government agency to operate its program without a limit on the amount of money to be spent is new. There is very little data on which to base an unqualified evaluation. There are, however, several views of the idea and its relevance to governmental financing.

Closest to Business-style Financing

The open funding concept is closer to the methods used by private corporations for fiscal management than any other method used in government to exercise fiscal control. In the private sector, if a company engaged in wholesale and retail marketing wants to increase its profits, it must spend more money to increase inventory, advertise more, expand display space, etc., so that gross sales can be increased. Since profits are usually a percentage of sales, sales must be increased to generate more profits. At times, profits can be increased by reducing expenses while maintaining the same sales amount.

Hazards of Fixed Appropriations

Typically, government agencies are provided with a fixed number of dollars to spend during the budget period. Future budgets are usually based on recent past performance of the agency. An agency can be in serious trouble for not spending its appropriated amount. Spending less often results in difficulty getting the next period's budget request approved. Underspending is commonly interpreted as an indication of poor estimating by the agency head, which is assumed to still exist. Therefore, rather than being rewarded for holding down expenditures, the manager is punished for bad estimating by having his new budget request reduced by at least a comparable amount. On the other extreme, spending more than authorized is usually interpreted as poor management and lack of fiscal control. It may result in the criminal liability of the agency manager.

Concentrate on Agency Programs

In those types of agencies where it is feasible, a method of open funding avoids these pitfalls of specific spending authority and allows them to "get out of the burden of general fund appropriation."¹ The agency is able then to concentrate on seeing that it accomplishes its programs in an efficient manner. The agency head does not "spend two years concerned

with spending the exact amount of appropriation rather than servicing customers."² Any funding method that lifts the burden of spending all of an appropriation may help to reduce government spending. An examination of almost any agency's spending records will disclose expenditures near the end of a fiscal period that are intended to use up the appropriation so it is not lost and does not cause future budget requests to be cut.

Not Without Problem Areas

The commonly used funding methods with their strict controls have evolved over a long period. The primary reason for the strict controls is the unscrupulous people who have gotten into managerial positions and "ripped off" the public by misspending.

Question of Interim Control

The strict controls have become the means for preventing such activity. Attempts are made to design features into the controls to allow examination during the interim between legislative sessions. For example, normal line-item expenses are apportioned in such a way that when the budget period is half over, the item's appropriation is approximately half spent.

With the open funding methods there is no fixed appropriation amount to apportion to parts of the budget period. Gone is that interim control. It might be possible to make some evaluations based on reasonable proportion data, but this is more difficult and not as reliable as the apportioning of a fixed appropriation.³ Some examples of reasonable proportion data would be limiting operating expenses to a fixed percentage of gross or net proceeds, a maximum amount of operating expense per customer served, or, as used for the Liquor Division, requiring a minimum profit margin based on sales.

Faith and Trust are Mandatory

In order for open funding to work, the legislature must have faith and trust in the agency head. Our mobile society does not place a heavy obligation on the agency head to remain in that position to the end of the budget period. He or she may leave and be replaced by someone with inferior qualifications or who is much less trustworthy. Or, something may happen to cause the manager to "go off the deep end" and spend money for some large item or idea that just doesn't work out. The taxpayers could well be left holding the bag.

Is Government Out of Its Element?

A somewhat contrasting view holds that government should not be in business. The purpose of government is to accomplish those things for the general public that are impossible, impractical or prohibitively costly for each person to do for themselves. Conducting a business for profit cannot be included in this definition.

Government Not Designed to Make Profits

Most of the functions that government was initially intended to perform are not those that produce or generate revenue; they are public services, such as police and fire protection, welfare, etc. Any revenue generating functions are devised, almost as an afterthought, to provide some of the money to pay for those services. The thought of any agency trying to make a profit for the general fund coffers is a relatively recent development. It usually is associated with agencies whose main function is to control or limit an activity.

Profit Should Be for Private Enterprise

In a government operated business, the profit incentive is lacking for management.⁴ The Montana Liquor Division Administrator is paid a fixed salary set by his position

classification and the state pay scale. There is no bonus or other financial incentive for producing more profit than that required by the legislature. The incentives remaining available include prestige, opportunity for advancement and, in this case, the threat of the Liquor Division being closed down by the Legislature for failure to earn the \$13 million in profits. In the private sector it is quite common for upper management people to receive a portion of the profit their organization produces. The incentives are there to encourage actions that will maximize profits.

The argument could be made that the profit generated by Montana's liquor monopoly is beneficial because it supplements taxes which contribute to the general fund, a form of tax relief. The obvious answer to difficulty accepting the idea of a government agency making a profit is to increase the tax rate by the profit margin and not call it profit. Another answer is that if liquor distribution in Montana were handled by private businesses, the profit they make and the capital facilities they own would form part of the taxable base.⁵ This simply transfers the income from liquor profits to tax revenue.

Shifting the distribution and marketing functions to the private sector would place more job opportunities in the private sector. This allows a relationship to develop between productivity and general wealth. Under a private enterprise

system, the rewards then become commensurate with productivity. Also, shifting jobs from a government agency to private businesses helps to reduce the size of government. A side benefit is that it relieves some of the burden from the public pension plans, shifting it to private pension plans.⁶

These questions can be legitimately raised, however, since they represent policy decisions rightly to be made by the Legislature, they will not be dealt with in this paper. The issue being discussed is not whether profit-making agencies should exist in government, but whether, when they do exist, they should be financed by an open funding method.

Summary

In this chapter we have taken a brief look at some differing views of the concept of open funding for a profit-oriented government agency. It is the funding method that is most like private enterprise. Open funding allows the agency management to concentrate on running their programs rather than on spending the exact amount of their appropriation. The question was raised whether a government agency should be in business for profit or whether it might be better to turn the function over to private enterprise and let the profit revenue be made up through increased excise taxes and increased taxable base for other taxes. This question is not answered because it

represents a policy decision that is beyond the scope of this paper. The remainder of this paper will deal with evaluating open funding as a method for funding profit-oriented government agencies.

Footnotes

1. Interview with State Representative John M. Shontz (Dem., Dist. 53, Richland County), Helena, Montana, April 7, 1981.
2. Interview with Leon J. Messerly, Administrator, Montana Department of Revenue, Liquor Division, Helena, Montana, April 16, 1981.
3. Interview with JanDee May, Budget Analyst, Office of the Legislative Fiscal Analyst, Helena, Montana, April 8, 1981.
4. Interview with State Senator Thomas F. Keating (Rep., Dist. 32, Yellowstone County), Helena, Montana, April 16, 1981.
5. Ibid.
6. Ibid.

CHAPTER IV

AN EVALUATION OF OPEN FUNDING

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AN EVALUATION OF OPEN FUNDING

The Montana liquor monopoly case has been looked at from an historical standpoint and in terms of present status and future plans. Some differing views concerning the concepts of open funding and profit-oriented government enterprise have been briefly discussed. Now, it is time to evaluate the concept based on this study.

Synopsis of Study and Findings

Montana's present liquor monopoly had its beginnings in 1933 with the end of national prohibition. The intent then was pure and simple: control the consumption of alcoholic beverages for the good of society. In the mid-1970's, documents indicated that primary emphasis was shifting from control of liquor to the production of revenue. The late 1970's saw a definite shift illustrated by Initiative 81 (passed in 1978) and in the 1980-81 biennium appropriations measure for the state's liquor operation.

As the 1980-81 biennium began to unfold, there was a shadow over the Montana liquor monopoly. Six months into the biennium sales were down much more than had been anticipated.

would, indeed, make the mandated \$13 million profit with about \$400 thousand to spare. These results apparently were convincing enough. The 1981 Legislature repeated the open appropriation for the Liquor Division. The profit requirement remained the same at \$13 million, but the division was given a little more freedom in achieving it.

From interviews with members of the 1981 joint appropriation subcommittee that worked on the Liquor Division budget, it appeared that their opinion of the open funding method was practically unanimous. One member interviewed, Senator Thomas F. Keating (Rep., Dist. 32), felt that the state should not be in the retail liquor business, but that, since it is, the open funding method is the best way to fund such an operation.

Based on the results achieved by the Montana Liquor Division during the 1980-81 biennium against heavy odds (the loss of sales because of Initiative 81 and the change in legal age minimum for drinking, and, what turned out to be a year of general economic depression) and on the consensus reached by the joint appropriation subcommittee, it can be concluded that the open funding method is the best way to fund a profit generating program such as the Montana liquor monopoly. The open funding concept may also merit consideration as the funding method for other areas of government that charge a fee

or price for the service or product they provide. The benefits of open funding outweigh its drawbacks when it is applied to a government agency that generates revenue by virtue of its operation. Agencies that are nearly self-supporting might be brought to that position if its administration were freed from the burdens of a fixed appropriation and allowed to operate the agency in the manner of a private sector business.

Should Government Be in Business?

As mentioned in Chapter III, the purpose of government is to accomplish for the general populace those things which are impossible, impractical or too costly for people to do individually. Government has been given the authority to levy and collect taxes in order to provide funding for the services provided and for administration of these services. The population has grown from largely rural (independent) to largely urban (dependent on the government and others). It has become necessary for the government to take on some activities intended to protect people from the damaging actions of others. This latter purpose includes controlling alcohol abuse, drug abuse, criminal acts, etc. The case concerning the Montana liquor monopoly falls into this latter category.¹

Admittedly, there are possible advantages in shifting the distribution and marketing to the private sector. There would

be a definite profit incentive for private sector management that does not exist in government. The profits generated in the private sector become taxable income and the capital assets add to the property tax base. The shift to the private sector also would shift job opportunities, thus helping to reduce the size of government.² However, shifting liquor distribution and marketing to private enterprise would essentially eliminate what little control now exists and would likely result in a price increase to the consumers.³ The idea of the price increasing when a monopoly is turned over to private enterprise is contrary to all economic theory, which assumes that the free enterprise market results in the lowest possible prices. The explanation is that the current state operated monopoly is able, through volume purchasing, to take advantage of the economy of size and thereby keep prices artificially low.

Based on the factors discussed earlier, it can be deduced that the general populace of Montana would receive greater benefit from the continuation of the current monopoly system than from the liquor distribution being turned over to private enterprise. Consumers will continue to enjoy the artificially low prices resulting from volume purchasing available to the state monopoly. The general populace of the state will continue to benefit from the reduced problem of alcoholism

brought about by the control that is being accomplished. And, the taxpayers of Montana will continue to benefit from the lessened increase in general taxes that is the result of supplementing general fund tax collections with the liquor profits. Under the present arrangement, all of the profit is deposited to the general fund. Under a private enterprise arrangement, only a small proportion of the profits would be deposited through income taxes.

Liquor Division Should Operate Like the Business It Is

The question about the propriety of the state being in the liquor distributing and marketing business must be answered by the people of the state through the legislature. For the time being, the state is in the business, and, this must be accepted as we evaluate this new funding method being used for the Liquor Division.

Avoid Fixed Spending Limit

Since most private enterprise businesses operate without a fixed spending limit, the Liquor Division should operate the same way. This would allow the administrator's concentration to be properly fixed upon the division's goals of serving the customers and generating taxes and profits for the state. Management would not be saddled with the spend-it-or-leave-it

syndrome which induces so much unnecessary spending. Whatever expenses are necessary to maximize profit could be decided by management without worrying about having prior specific approval from the legislature. Next fiscal period's budget could not be penalized for underspending this period.

Encourage Profit Management

With the cry of budget cutting ringing in our ears, why should we recommend a blanket spending authority instead of a lower limitation of spending? By avoiding the problems of a fixed spending limit, as discussed above, the Liquor Division management can concentrate on increasing the efficiency of their operations. Operations can be analyzed and changes devised to allow more sales at the same manpower and expense levels without worrying whether the increased inventory purchases will overspend the limited appropriation amount. Bonus plans and similar benefits can be designed to reward increased productivity at the store level. New marketing techniques and the products of new technology can be used as long as they are individually justifiable. They would not have to be discarded or postponed simply because they weren't included in the appropriation.

Limited Applications

An open or unlimited spending authority is not feasible for all governmental agencies. It would only work for those that bring in money in exchange for goods or services, and then, only if it is possible for income to at least equal expenditures. Also, the possibility of the government agency posing "unfair" competition to the private sector must be taken into consideration.

Government's Purpose is to Serve

It was mentioned in Chapter III that the purpose of government is to provide services for the public that they cannot provide for themselves. Government provides protection of individual rights under the Constitution. It provides social services for the needy. It provides police, fire and legal services; and on, and on, and on. It would take a large book to simply list all the services provided by governments in the United States. In order to pay for all these services, taxes are levied and collected. The Department of Revenue handles this chore for the State of Montana. It would be inappropriate for tax collecting divisions of the department to be given open funding to influence profit-oriented management. The Department of Revenue is to serve the taxpayers by equitably administering the state tax laws, not by extracting taxes from the private sector.⁴

Some areas other than the liquor monopoly that could feasibly be given open spending authority are those which provide services for a fee. For example, the Department of Fish, Wildlife and Parks game management and parks and recreation area maintenance programs could each have open spending authority with the provision that expenditures not exceed the total of fees received and funds received from other government agencies (federal matching funds, transfers from State Lands Bureau, etc.). Department of Revenue, Recovery Services Division could have the limitation that expenditures not exceed the total amount of debts recovered plus federal expense contributions.⁵ The Department of Highways could be limited within major expense categories to the totals of specific earmarked funds and federal matching funds.

More Purpose for Revolving and Earmarked Funds

Using the form of flexible spending authority discussed above for agencies other than the Liquor Division would help restore some real purpose to revolving accounts and earmarked funds. Presently, they seem to only be a way of saying, "That money's mine, and you can't touch it!" There are at least two other benefits of flexible spending authority. First, agencies can more easily and more quickly reduce or expand their programs to fit the needs of their customers. They will

be able to predict the need for reduction or expansion through analysis of their fee income. Second, if surplus or unspent income is not required to revert to the general fund at the end of each fiscal year, the agencies can save up for planned future major expenditures and the spend-it-or-lose-it syndrome can be avoided. This will result in an overall savings to those providing the funding source: the customers being served.

This could raise the issue of legislative control of the purse strings. However, if an agency is going to be in business for a profit, then it should be permitted to operate in the manner of a business.

Profit is Permissible for Liquor Division

Half of the reason for having a liquor monopoly in Montana is to control the consumption of alcoholic beverages. Part of that control is achieved through the prices charged for the liquor. Of the percentage added to the price by Montana, a small amount is the freight cost of getting it to the consumer, the rest is taxes and profit. The taxes are set by statute and are subject to change only every two years. The profit is more flexible and, for the 1982-83 biennium at least, at the discretion of the Liquor Division. Altering the profit margin would have the tendency to affect the control of consumption and the profits generated in opposite directions. That is,

increasing the profit margin would also increase prices which should tend to reduce consumption.

The excise tax on liquor could be increased by the amount of markup desired. This would result in approximately the same revenue and would eliminate the term "profit" along with any connotations it might have. This action would be much less flexible. The amount of revenue would be much more dependent on economic conditions. This would make the amount of money available for the legislature to appropriate even less predictable than it is now.

Conclusions

Considering the success with which the Liquor Division appears to be meeting its goal for the 1980-81 biennium in spite of adverse economic conditions, it would be difficult not to recommend that the open funding method be tried again. The cries from government critics have been, "Government is too big! Let's reduce the size of government." and "Government should be run like a business." Preliminary results indicate that the Liquor Division has done just that. In a time of economic depression and sales loss to private competition, the Liquor Division has managed to maintain the same amount of profit--just what a private enterprise business would try to do. The Liquor Division has also reduced its staffing by

nearly twenty percent in a year and a half. Based on the results thus far and concurring with the legislative appropriation subcommittee, the open funding method is the best way to fund the Montana liquor monopoly.⁶

As for other agencies, they must be evaluated on an individual basis. It must be determined whether they have enough income generated directly by the services they provide or by earmarked revenues and/or other levels of government to be self-supporting. If this criteria is met and no other restrictions apply, then the agency could be considered as a candidate for open funding.

The only problem that is evident with open funding is establishing a technique for assuring control over the agencies' expenditures. Appropriate control methods need to be defined to fit the agency and its mix of funding sources. For the Liquor Division, relating the profit margin and operating expenses as a percentage of net sales appears to be a valid control. The Interim Finance Committee can look at year-to-date expenses, profits and sales and get an idea of how things are going. For other agencies, the use of a revolving account with observations of balance might be fitting. Under normal funding methods (fixed appropriations), the control can be exercised at the end of the fiscal period when it is determined that the executive branch manager has overspent the

agency's budget for the period. With an open funding method, using a reasonable proportion type of control, the control can be exercised continually during the fiscal period, as the proportion being controlled on should be relatively constant during the period. If an agency is going over the desired proportion, the manager can be so informed early in the fiscal period. The manager can then adjust the agency's spending to bring the proportion back within the desired range before the end of the fiscal period. Overspending has thus been prevented instead of discovered after it has happened.

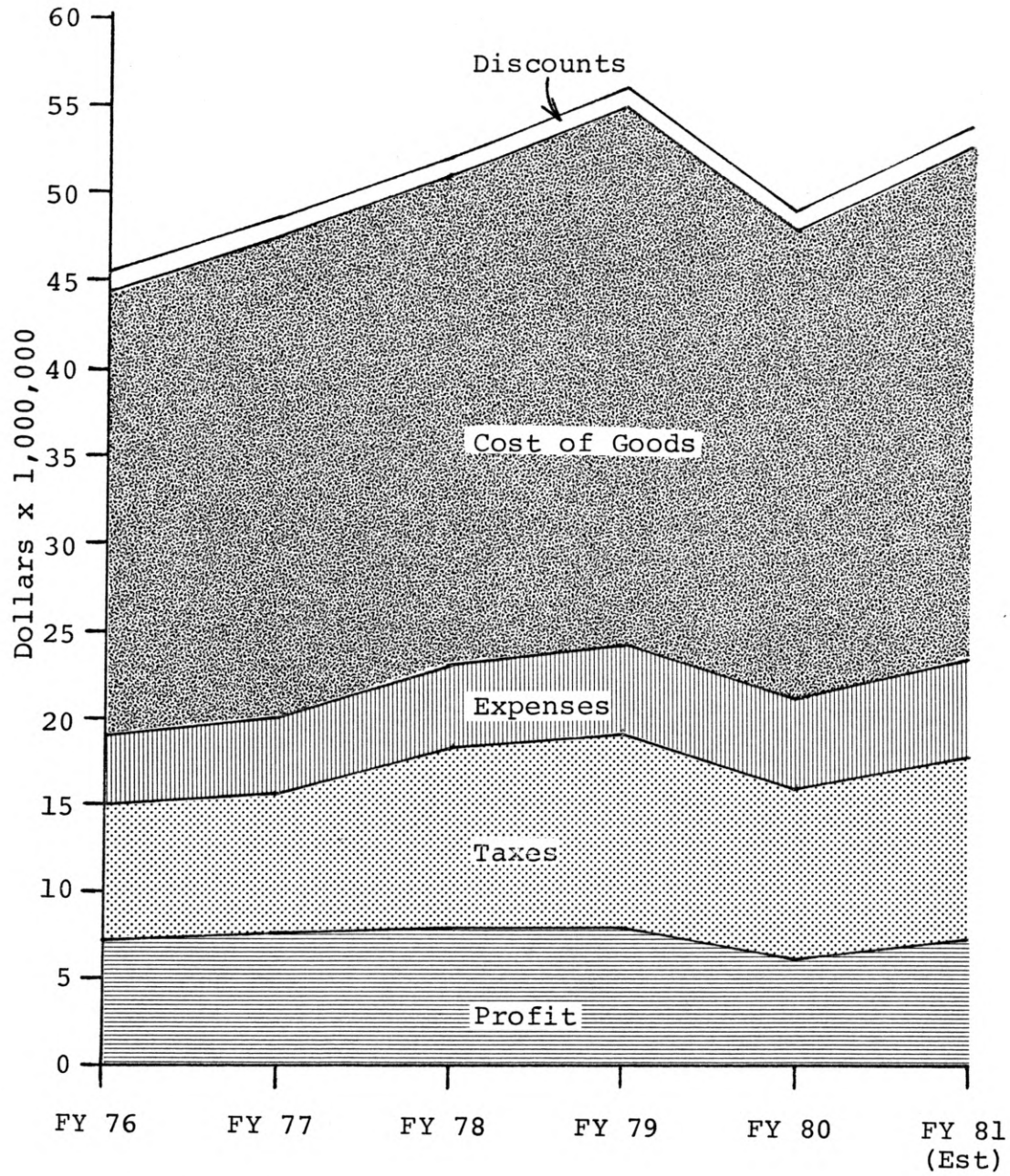
Footnotes

1. The Montana liquor monopoly began immediately after Prohibition was repealed by ratification of the Twenty-First Amendment to the United States Constitution. Its initial purpose was to control the consumption of alcoholic beverages. However, the emphasis has shifted now to the production of revenue. Chapter I provides a more detailed historical summary.
2. Interview with State Senator Thomas F. Keating (Rep., Dist. 32, Yellowstone County), Helena, Montana, April 16, 1981.
3. Interview with State Representative John M. Shontz (Dem., Dist. 53, Richland County), Helena, Montana, April 7, 1981.
4. Interview with State Senator Thomas F. Keating, April 16, 1981.
5. The 1981 Montana Legislature gave the Department of Revenue, Recovery Services Division their basic budget request, but added the stipulation that if the division could recover \$1.05 per \$1.00 of expense in fiscal year 1982, they could increase their appropriation by up to \$16,000 in general funds and \$48,000 in federal funds for fiscal year 1983. 47th Legislature of the State of Montana, House Bill 500.
6. Interview with State Representative Earl C. Lory (Rep., Dist. 99, Missoula County), Helena, Montana, April 15, 1981.

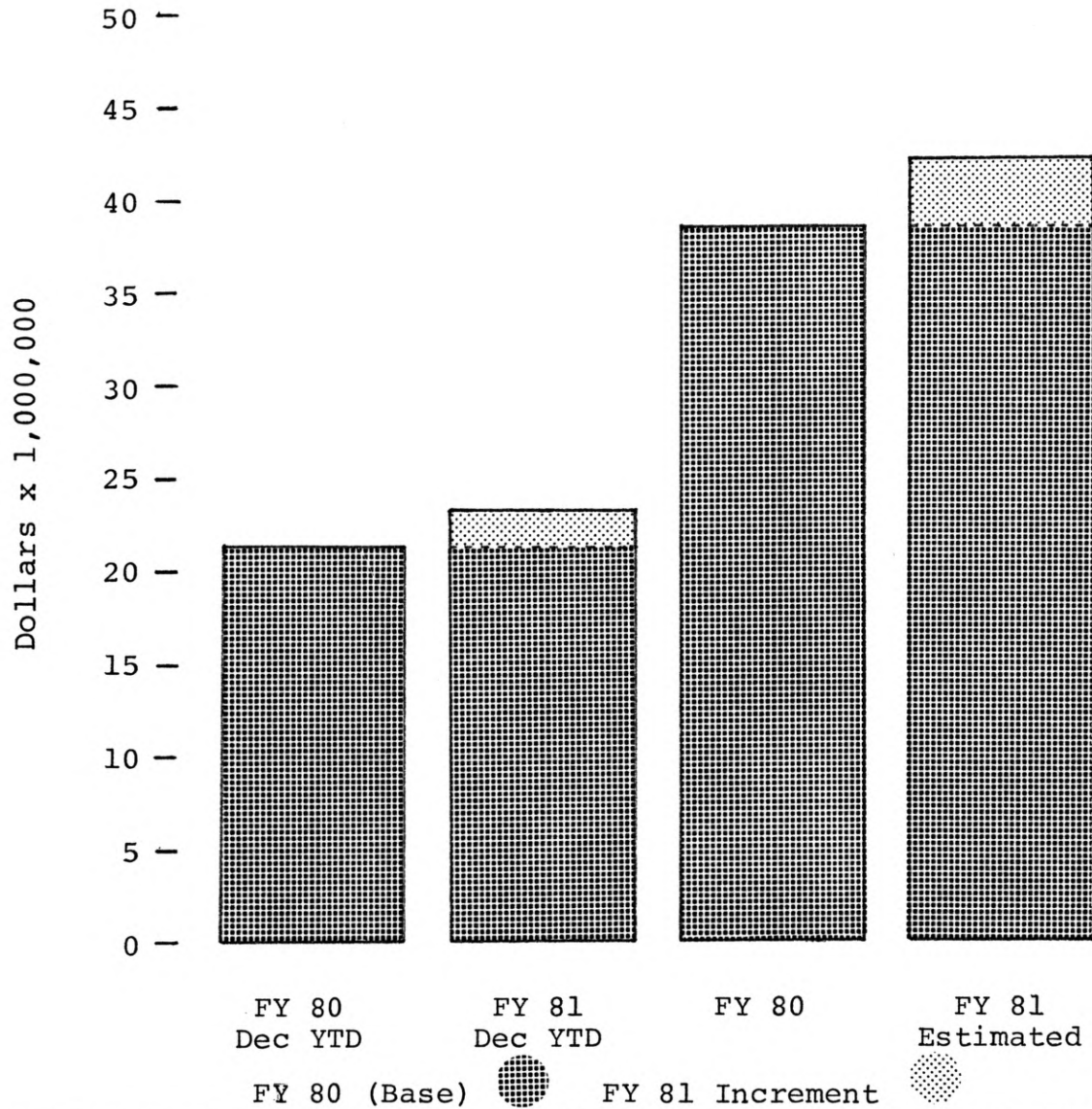
APPENDIX

Selected Charts
Showing
Liquor Division
Sales, Expenses, Profits and Their Distribution
During
Fiscal Years 1977 Through 1981

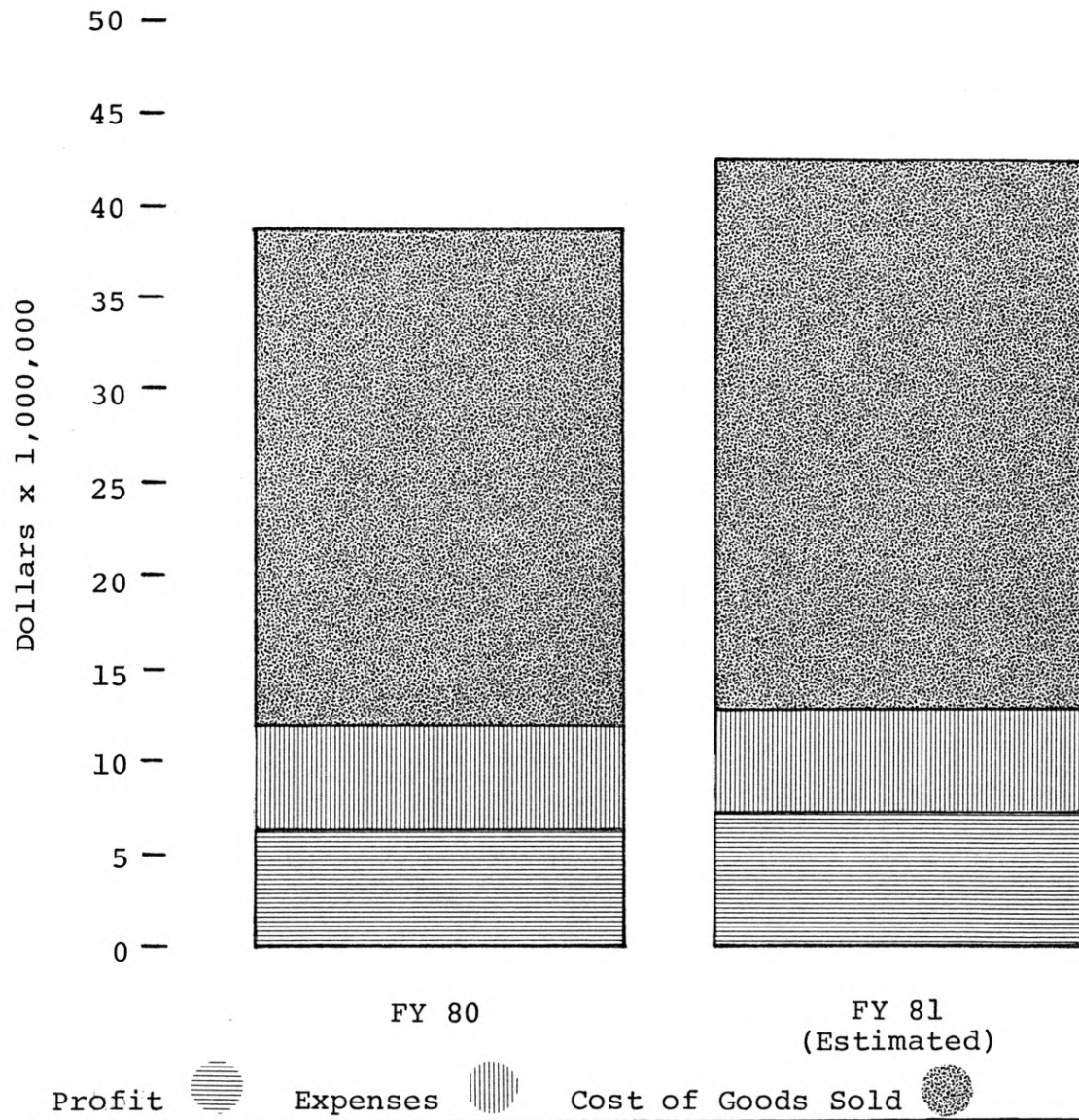
Selected from the
1981 budget Presentation
of
Montana Department of Revenue
Liquor Division



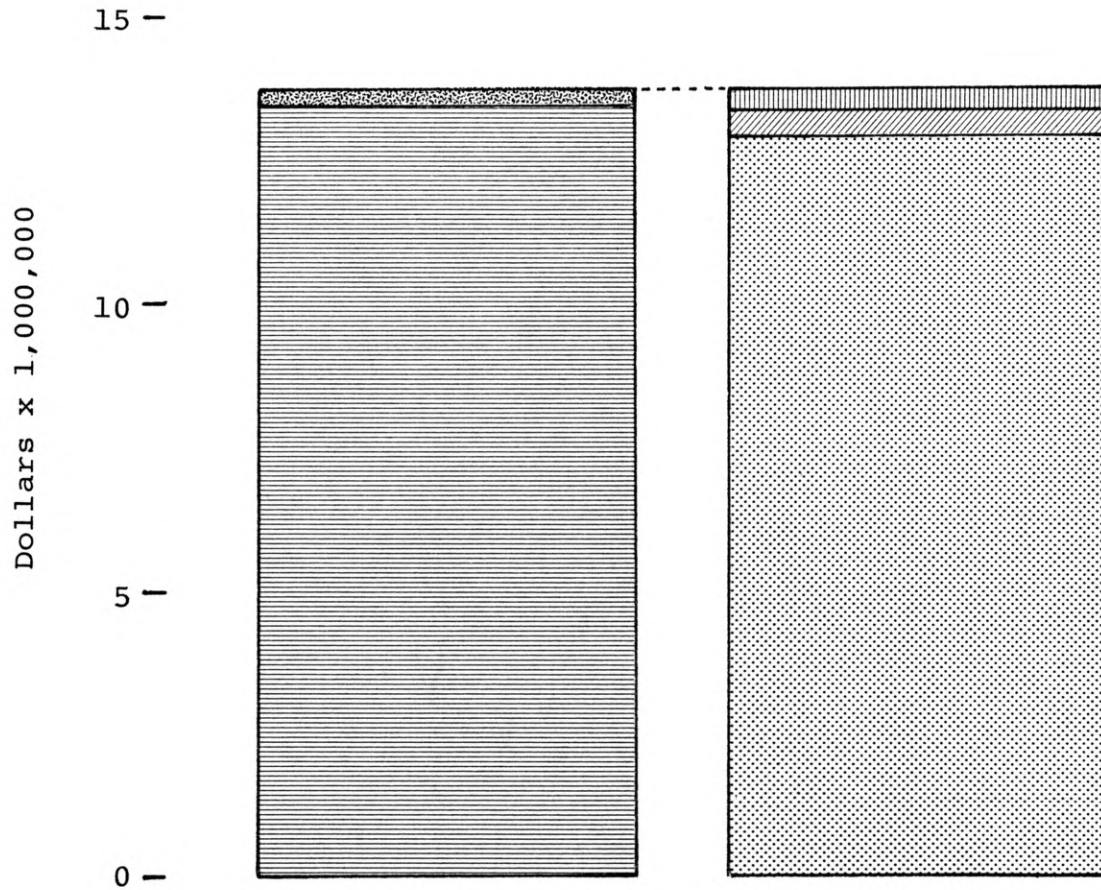
Distribution of Gross Sales for Fiscal Years 1976 Through 1980 and Estimates for Fiscal Year 1981.



Comparison of Net Liquor Sales for the First Half of Fiscal Years 1980 and 1981 and for All of Fiscal Year 1980 to Estimated Totals for Fiscal Year 1981.

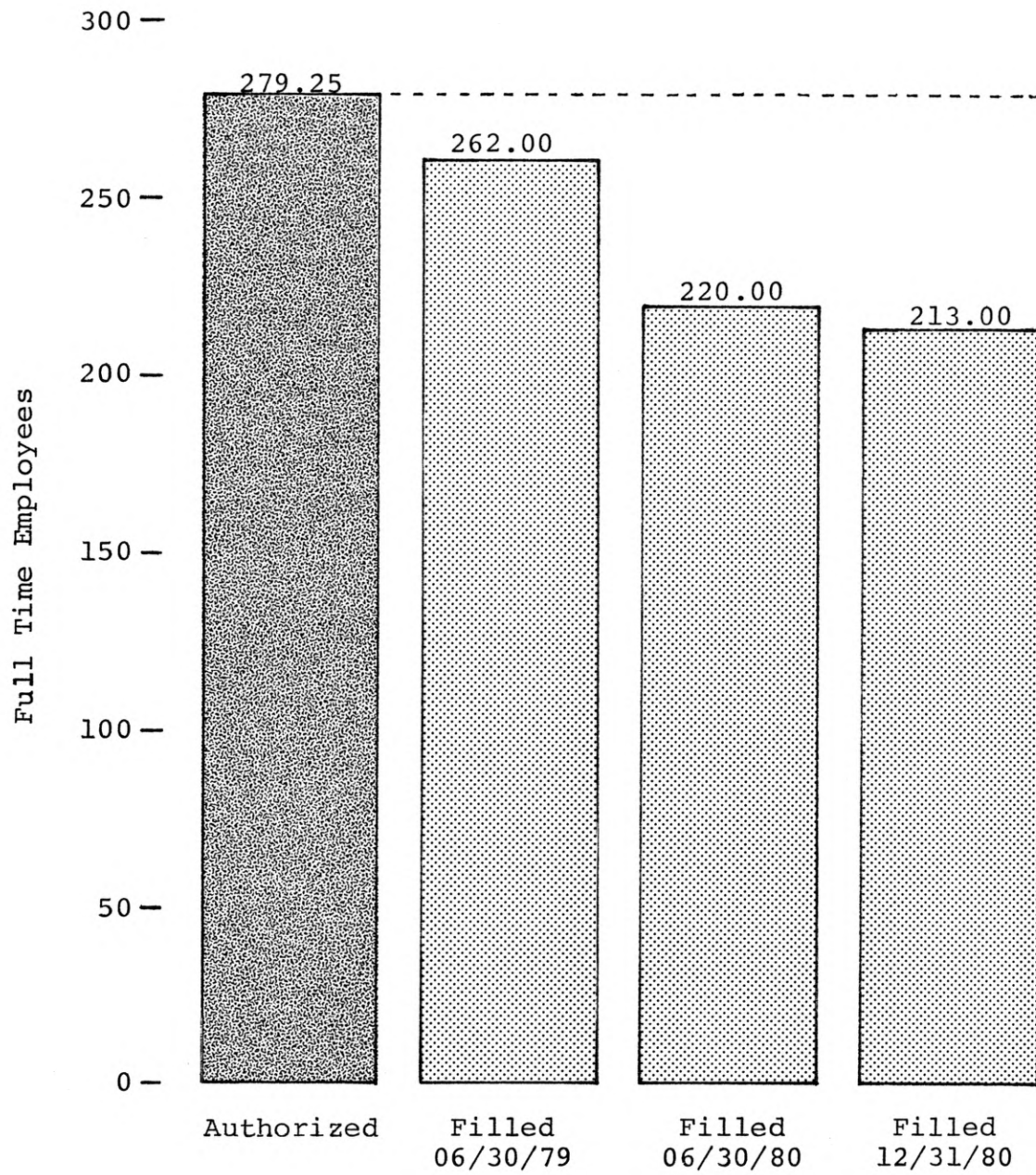


Relationships of Profit, Expenses and Cost of Goods Sold for Fiscal Year 1980 and Estimates for Fiscal Year 1981.

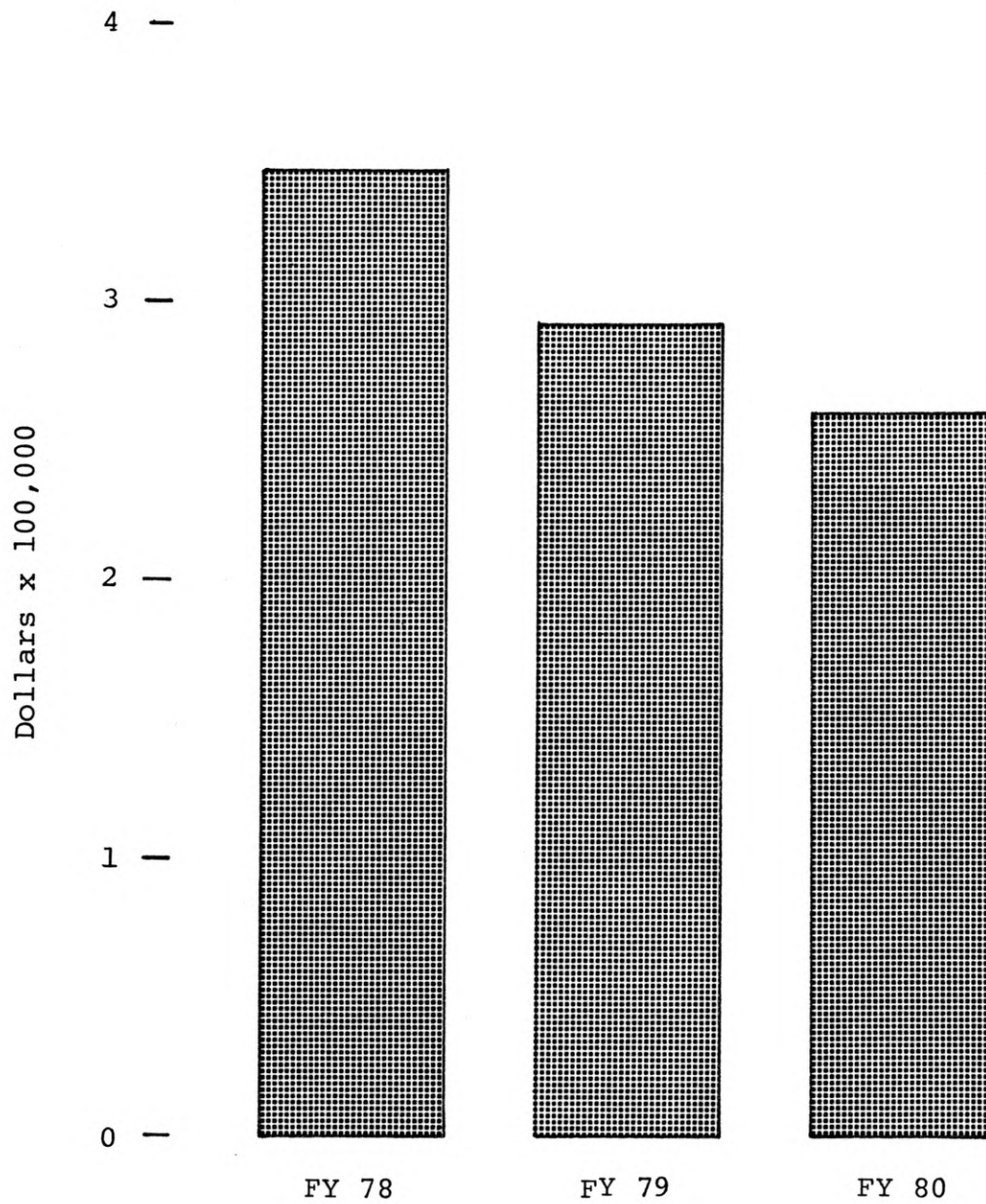


Profits  FY 79 Profit Adjustment 
 License Bureau Expenses 
 Investigation Division Expenses 
 Profit Available for Transfer 

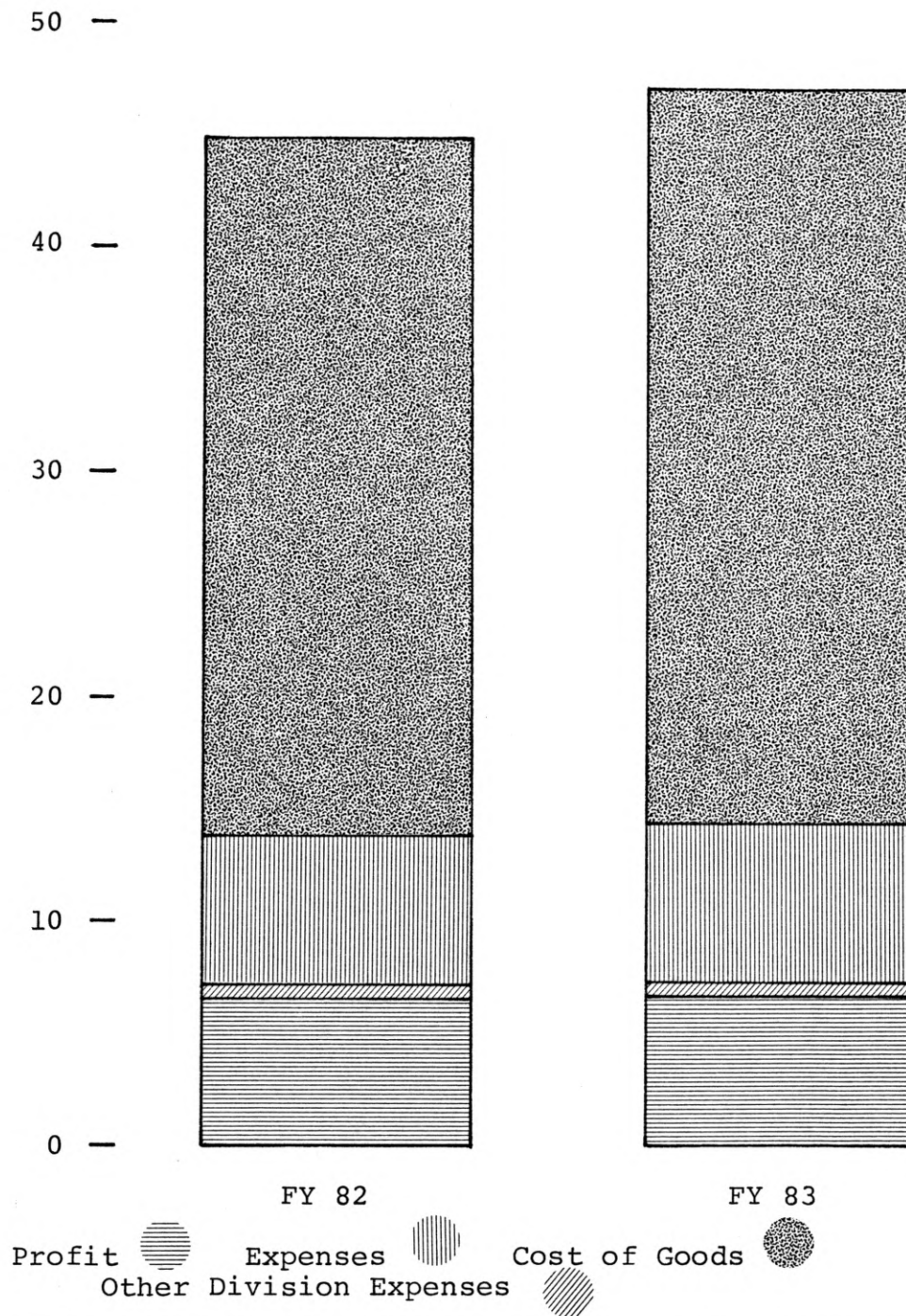
Estimated Fiscal Year 1980 and 1981 Liquor Store Profit Available for Distribution to the General Fund.



Work Force Reduction from June 30, 1979 to December 31, 1980.



Part Time Help Expenditures fro Fiscal Years 1978,
1979 and 1980.



Estimated Liquor Sales Profits for Fiscal Years 1982 and 1983 Available for Distribution to General Fund.

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