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Regulation of Interstate Wine Shipments

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IN THE
Supreme Court of the United States

OCTOBER TERM, 2004

Jennifer M. Granholm v. Eleanor Heald, et al.
Michigan Beer & Wine Wholesalers Association v. Eleanor Heald, et al.

On Writ of Certiorari to the U.S. Court of Appeals for the Sixth Circuit

BRIEF OF GEORGE A. AKERLOF, DANIEL L. MCFADDEN, VERNON L. SMITH, DONALD J. BOUDREAUX, ROBERT W. HAHN, JOHN M. LETICHE, AND ROBERT E. LITAN AS *AMICI CURIAE* IN SUPPORT OF RESPONDENTS ELEANOR HEALD *ET AL.*

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QUESTION PRESENTED

Does a State's regulatory scheme that permits in-state wineries directly to ship alcohol to consumers but restricts the ability of out-of-state wineries to do so violate the dormant Commerce Clause in light of Sec. 2 of the Twenty-first Amendment?

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INTEREST OF AMICI CURIAE

This *amicus curiae* brief is submitted by a group of economists in support of respondents Eleanor Heald *et al*. (cases 03-1116 and 03-1120). The individual signatories on this brief are leading economics scholars whose contributions to the study of consumer markets have enjoyed national and international recognition and acclaim.

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The economists were assembled by the Henry Wine Group, a for-profit corporation domiciled in California.[1] The Henry Wine Group is the largest importer, distributor, and broker in the United States dealing exclusively in fine wines. The firm's business model, which emphasizes quality services to suppliers and customers, rests on the recognition that the special needs of

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[1] No party authored this brief in whole or in part, and no person except amicus Henry Wine Group made a monetary contribution to the preparation and submission of this brief. See S. Ct. R. 37.6.

fine wine suppliers and their customers are not being met by the dominant, spirits-driven wholesale distributors. Protectionist state regulations constitute a significant obstacle to the Henry Wine Group's growth and market penetration outside California.

For many years, the company's leading officers have played an active role in a national campaign against antiquated and inefficient wine marketing restrictions. In their experience, economic considerations and, in particular, the consumer benefits that would likely flow from a more open wine market have often received too little recognition in a debate where regulatory concerns, interest group politics, and weighty constitutional questions all intersect. Accordingly, the Henry Wine Group asked the signatories to provide a fuller picture of the wine market and its regulatory environment, which may be powerfully affected by these cases. We claim no constitutional expertise, and we submit this brief entirely in our capacity as economists and on the economic background and implications of the direct shipment regulations here at issue. All parties have consented to the filing of this brief.

SUMMARY OF ARGUMENT

Throughout the United States, wine is commonly sold under a "three-tier" system: producer to wholesaler to retailer. Most states prohibit vertical integration between the tiers, and most protect the three-tier system through a variety of regulatory means. Among the most common restrictions are limitations or outright bans on direct sales from producers to consumers.

Direct shipping restrictions, and especially bans on direct interstate shipments, are measures of a type that quite likely would inflict welfare losses on consumers and on many wine producers, especially smaller market participants. If existing state restrictions on direct interstate shipments were removed, there would be more competition, which would have a positive impact on consumer and social welfare (that is, the total surplus of consumers and producers).

As we read the briefs submitted by the state parties and their *amici* in these cases, they do not seriously contest either the economic costs of the regulatory regime nor, by implication, the potential benefits of a national wine market that is free from protectionist inhibitions. Rather, they contend that the existing restrictions are justified by other state interests, such as the promotion of temperance, the protection of minors, tax collection considerations, and the maintenance of orderly market conditions. These concerns, however, cannot justify the *discriminatory* laws at issue in these cases. More broadly, the history and the contours of state restrictions on direct shipments, as well as the empirical evidence from state markets that lack those restrictions, indicate that the proffered public-interest justifications are not persuasive. The available evidence supports the economists' expectation that restrictions on market entry often serve to protect highly organized and entrenched interest groups, to the detriment of consumer welfare.

To repeat, we neither possess nor claim expertise on the true scope of the Twenty-first Amendment. With that caveat, we argue that the principles of open state borders and non-discrimination, as they have been explicated in this Court's decisions under the Commerce Clause, are consistent with the economic profession's well-accepted views on the benefits of free trade and competitive markets. Those views support the invalidation of the discriminatory state regulations at issue in these cases.

I. DIRECT SHIPPING RESTRICTIONS DIMINISH CONSUMER AND ECONOMIC WELFARE

The U.S. wine market has been subject to relatively little systematic empirical or econometric analysis. That is unfortunate (for the purposes of these cases) but hardly surprising. Some markets—such as network industries, natural monopolies, or industries with declining marginal costs—cause a great deal of disagreement among economists. The wine market, in contrast, is a classic, competitive market, albeit a heavily regulated one. The dynamics of such markets and the consequences of regulatory interventions have been well-understood for many decades. The application of that expert consensus to the wine market and its regulatory context is straightforward.

A. State-Imposed Direct Shipping Restrictions Constitute a Significant Regulatory Barrier to an Efficient National Wine Market

Over the past 25 years, the United States wine market has undergone dramatic changes at the production stage, in the distribution process, and at the demand level. The present market conditions, insofar as they pertain to state-imposed direct shipping restrictions, are summarized with admirable clarity in a study by the staff of the Federal Trade Commission. Report from the Staff of the Federal Trade Commission, *Possible Anticompetitive Barriers to E-Commerce: Wine* (July 2003) *available at* http://www.ftc.gov/os/2003/07/winreport2.pdf (hereinafter FTC Report). The fact that petitioners and their *amici* do not bother to discuss the findings of the FTC Report provides further evidence of the soundness of the FTC staff's analysis.

The wine industry has been characterized both by a remarkably high degree of market entry on the part of wineries and by increased concentration on the part of distributors. "[A]s demand has increased for individualistic, hand-crafted wines, the number of wineries has grown dramatically, from between

500–800 in 1975 to well over 2,000 today." FTC Report at 6 (footnote citing estimates omitted). At the same time, concentration in the market for mass-marketed wines has increased. Thirty U.S. wine companies supply over 90 percent of U.S. production, and the top three firms account for 60 percent of volume. Gina M. Riekhof & Michael E. Sykuta, *Politics, Economics, and the Regulation of Direct Interstate Shipping in the Wine Industry*, CORI Working Paper 03-04 at 7 (citing estimates and sources) *available at* http://ssrn.com/abstract=481947 (hereinafter Riekhof & Sykuta). The distributor industry has experienced rapid concentration. Market participation has dropped from several thousand in the 1950s to a few hundred today. In some regions, the distributor market may be approaching near-monopolistic conditions, although systematic data appear to be unavailable. FTC Report at 6.

Clearly, state regulatory interventions impede competition at the wholesale level. Many states have enacted laws that grant wholesalers preferential contract rights, establish exclusive territorial arrangements between wholesalers and wineries,[2] and deter price cutting. The FTC has been sharply critical of some of these measures and their anti-competitive effects. FTC Report at 6–7 (listing examples). There is also some evidence that market concentration has increased at the retail level. Riekhof & Sykuta at 9–10.

At the consumer level, the demand for high-end wines—a luxury good—has increased with the general rise in prosperity. This group of consumers is largely composed of the wealthiest members of our society. The Wine Spectator—the most widely

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[2] Such arrangements are not necessarily anti-competitive. In some situations, they may well lower price and improve quality. However, in combination with other government interventions (such as laws that make it difficult for suppliers to terminate contracts with distributors), state-protected exclusive territories tend to produce anti-competitive outcomes. Douglas Glen Whitman, *Strange Brew: Alcohol and Government Monopoly* 27–28 (2003).

circulated magazine devoted exclusively to wines—counts upwards of 1.1 million readers, with a median household income of $144,500. Wine Spectator Advertising Information 3 (2003) *available at* http://www.winespectator.com/Wine/Images/Graphics/ads/WS_NAT_EKIT.pdf (hereinafter Wine Spectator). This segment of the overall wine-consuming populace appears to have grown rapidly and substantially over the past decade. For example, the Wine Spectator's paid circulation has increased from roughly 150,000 in 1994 to nearly 375,000 in 2003. Wine Spectator at 8. At the same time, the emergence of the Internet as a distribution channel has, in the states where direct purchases are permitted, substantially increased consumer access to rare high-end wines. Direct shipments are estimated at over $500 million, or 3% of the wine market. FTC Report at 5 (citing estimates).

In this changed market environment, the shrinking distributor network has resulted in a bottleneck. And market participants, not surprisingly, have attempted to bypass this bottleneck. Large wineries have created their own distribution systems, where that is permitted by law. Small wineries, for their part, have sought to avail themselves of direct-sales opportunities. Those firms, often producing no more than two or three-thousand cases per year, cannot supply the volume required for mass distribution. For distributors, carrying small-volume wines entails high transaction costs. Distributors are typically responsible for promotional activities, such as wine tastings. Small-scale sales do not warrant such expenditures. As a result, "only the 50 to 100 largest wineries are able to secure widespread representation in distribution networks." Alan E. Wiseman & Jerry Ellig, *Market and Nonmarket Barriers to Internet Wine Sales: The Case of Virginia*, 6:2 Business and Politics at 5 (2004) *available at* http://www.bepress.com/bap/vol6/iss2/art4 (hereinafter Virginia Study). Small wineries typically use direct shipments as their primary means of accessing the national market. E-commerce has rendered such sales viable, but regulatory prohibitions on direct shipments in many states bar mutually beneficial transactions among small wineries and their consumers.

We know of no systematic effort to quantify the welfare effects of the existing direct shipment restrictions. Highly illustrative evidence, however, comes from the Virginia Study, the only available empirical comparison of the online and off-line wine markets. The study was conducted in 2002 in the area of McLean, Virginia, when Virginia administered a ban on direct interstate shipments (since lifted). The authors compared online prices and availability of 83 popular wines, identified through a poll that incorporates consumer preferences, with off-line prices and availability in the McLean area. Availability was unambiguously higher online. Even among the most popular twenty wines, eight were unavailable in the McLean area. Price comparisons, predictably, varied greatly with purchase quantity, the price level of wines, and delivery method for online purchases. Since transportation costs do not change with the price of wine, and since transportation costs constitute a larger proportion of total cost for low-volume shipments, online purchases are not a winning proposition for the connoisseur's sampling purposes (let alone a teenager's instant gratification). Unsurprisingly, though, the Virginia Study found substantial price advantages for online, by-the-case purchases of high-end wines. Direct shipment, in other words, generates economic benefits for the customer base that matches the Wine Spectator's readership, more than two-thirds of which report by-the-case wine purchases. Wine Spectator at 6.

The magnitude of the welfare losses that attend to direct shipping restrictions cannot be estimated with any confidence. Virginia Study at 20 n.38 (noting that a comprehensive welfare analysis would require additional, currently unavailable data). It is clear, however, that there exists a robust demand for online wine purchases and a producer and distribution base to serve that demand. One cannot reasonably contest the FTC staff's conclusion that "[s]tate bans on interstate direct shipping of wine represent the single largest regulatory barrier to expanded e-commerce in wine." FTC Report at 3.

B. The Demise of Direct Shipping Restrictions Would Yield Economic Benefits

These cases do not challenge direct shipping restrictions per se. They challenge only *discriminatory* barriers to direct wine shipments. If those barriers were invalidated (as we urge the Court to do), Michigan and other states would remain free to erect those same barriers on a non-discriminatory basis. *Beskind v. Easley*, 325 F.3d 506, 518–519 (4th Cir. 2003). That lawful policy choice, however, would be bad economic policy.

The petitioners and their *amici* defend direct shipment restrictions on wine as an urgent exercise of the states' police powers and their interests in encouraging temperance, fighting teenage drinking, and ensuring tax collection. We do not dispute the legitimacy of those objectives. As economists, however, we are trained to demand evidence, and, moreover to weigh all of the costs and benefits of a particular public policy. On both counts, the petitioners' policy positions and assertions are unpersuasive.

The FTC Report provides no reason to believe that the demise of direct shipping restrictions would lead to the dire consequences predicted by the petitioners and their *amici*. The FTC staff conducted an extensive review of the experience in states that already permit direct interstate shipment of wine. Surveyed state officials reported "that they have experienced few, if any, problems with interstate direct shipment of wine to minors." FTC Report at 31. That observation is consistent with the economic evidence that Internet purchases of wine are an uneconomical and therefore unlikely proposition for teenagers.

Similarly, many states have adopted less restrictive means than an outright prohibition on direct interstate shipments, and those states report "few, if any" problems with tax collection. *Id.* at 38. The permit systems administered by many states appear to be a viable means of ensuring tax collection. *Id*. at 38–40. In that light, it is not surprising that the great majority of lower courts have concluded that states have less restrictive means than a ban on direct interstate shipments to enforce legitimate state objectives. *Id.* at 27–29 (summarizing cases).

Similarly, the state's *amici* have warned that the invalidation of Michigan's laws would spell the collapse of the three-tier system not only for wine but also for beer and liquor. *See, e.g.*, Brief of National Beer Wholesalers Association in Support of Petitioners at 4 (Sixth Circuit decision in this case "toppled a comprehensive three-tier system governing the distribution of intoxicating liquor"). That contention grossly exaggerates the likely consequences on the distribution system and, moreover, ignores the economic benefits of broader market access. The invalidation of direct shipping restrictions would favorably affect the availability and, most likely, the price of many wines. Both effects would enhance consumer welfare. The likely effects on industry structure and in particular the three-tier system are indeterminate, as they will depend on market participants' responses and on regulatory interventions. The most likely effect, however, is a more efficient distribution system.

(i) Availability. A key effect of direct shipping restrictions is not to reduce the aggregate supply of wine (adults can buy all the wine they want) but rather to compress the range of choice. Inventory costs and diseconomies of scale prevent wholesalers and retailers from offering anything remotely comparable to the breadth of choice of wines and vintages offered by producers. Due to economic necessity, the distribution network limits the choice to a relative handful of well-known brands. A reasonable estimate of the welfare losses associated with the unavailability of many wines would require systematic information on elasticities and product substitution in this market. We do not possess such information. Elementary economic reasoning and casual empirical information, however, suggest that those losses very likely could be significant.

As noted earlier, the principal purchasers of direct shipment are frequent consumers of high-end wines, who purchase the goods for future rather than immediate consumption. The revealed preferences of these consumers indicate that they view limited selection as anything but trivial. They would not subscribe to expensive magazines, let alone devote time to reading them, if they were indifferent between one Chardonnay and the next. Wholly apart from price effects and even quality, supply diversification itself has sizeable benefits for consumers who want to stock a respectable wine cellar (much as liquid and diversified equity markets benefit financial investors). Moreover, these consumers confront very high opportunity costs in the form of lost income or foregone leisure time. These costs mount as consumers spend time in traffic on the way to distant specialty retail stores, instead of selecting and purchasing wines—from a much greater variety—on the Internet. Needless to say, nothing in economic theory commands special preference for rich, time-pressed consumers. But nothing, either, warrants a dismissal of the welfare losses that occur as a result of anti-competitive regulation whose effects are especially felt in this segment of the populace.

The demise of direct shipping regulations would necessarily expand selection and availability, as no regional retail market (let alone an individual retailer) can possibly offer the variety that is available on the Internet. However, market participants will not remain idle when confronted with increased competition. Broader availability of wines through direct shipping will likely increase selection at the retail level (certainly among local specialty retailers, if not necessarily within individual sales locations). Retail demand, in turn, may well prompt efforts at the distributor level to supply a greater variety of wines.

(ii) Price. While the likely price effects of a demise of direct shipping restrictions for wine are more conjectural than the predictable and unambiguously salutary effects on selection, general economic evidence strongly suggests that the elimination of artificial barriers to market entry should reduce prices. Economic models show conflicting results with respect to the price effects of Internet sales. Virginia Study at 9–11; FTC Report at 16–17 and sources cited *id*. n.75. The Virginia Study, as noted, showed substantial price advantages for by-the-case purchases of high-end wines over the Internet. As the authors observe, the static design of that study—conducted in a jurisdiction where direct shipments were prohibited at the time—permits no inference concerning the price effects (let alone the welfare effects) under competitive conditions. Virginia Study at 29. Still, the evidence of that study is consistent with the economists' ordinary expectations about the price effects of broader competition: prices should generally drop, though not necessarily for all wines. That expectation is further buttressed by considerations of political economy, more fully discussed below. The fact that the three-tier system enjoys government protection in many states suggests that those protections generate surplus profits, which are likely to accrue to distributors in the form of economic rents and to consumers in the form of higher prices. The demise of direct shipping prohibitions would—in the absence of other government barriers to broader market entry—erode those rents and redound to consumers' benefit. FTC Report at 23.

(iii) Market Structure. The state defendants and their *amici* in these cases—in particular, wholesalers—have intimated that the invalidation of discriminatory direct shipping regulations would spell the demise of the three-tiered system. Brief for the Wine and Spirits Wholesalers of America in Support of Petitioners at 4, 24. In contrast, those same interests have described the existing, mandatory three-tier system as efficient. C. Boyden Gray, *Written Statement on Behalf of Wine and Spirits Wholesalers of America* at 2 (2002) *available at* http://www.ftc.gov/opp/ecommerce/anticompetitive/panel/gray.pdf.; FTC Report at 22 (citing additional sources). These positions are inconsistent.

A three-tier market structure is efficient in many settings. That is why it exists in many unregulated commodity markets, and why it continues to exist with respect to wine sales in states that do not mandate a three-tier structure (such as California) or that permit direct sales subject to some restrictions (such as Illinois). Daniel L. McFadden, *Interstate Wine Shipments and E-Commerce* at 3 (2002) *available at* http://www.ftc.gov/opp/ecommerce/anticompetitive/panels/mcfadden.pdf (hereinafter McFadden). Specialization, efficiencies of scale, and other considerations often justify "middlemen" and their mark-ups.

What is at stake, however, is not the three-tiered system per se but rather the governmental imposition and protection of that system. The fact that many wine market participants have attempted to bypass the distributor bottleneck at both ends shows that a three-tiered system—especially where it is artificially imposed—is inefficient for those firms. For example, Australia's Foster's Brewing Company in 2001 acquired Beringer's, a large California winery, to leverage Beringer's distribution system for Foster's U.S. market expansion. Other market participants, including *amicus* Henry Wine Group, have consolidated portfolios of smaller wineries to build distribution capacity. Such vertical integration and acquisitions indicate that the costs of equivalent market access through arms-length market transactions must be quite high. Riekhof & Sykuta at 10; Ronald H. Coase, *The Nature of the Firm*, 4 Economica 386 (1937). Similarly, small wineries, in concert with consumer groups and non-profit law firms, have waged a long and determined campaign against wine marketing restrictions. Such investments suggest that the gains from reducing barriers to entry very likely could be sizable.

No one can confidently predict the market structure consequences of deregulating the wine market—

any more than the economists who predicted substantial consumer gains from airline deregulation could predict the market structure that would emerge (*see*, *e.g*., Michael E. Levine, *Is Regulation Necessary? California Air Transportation and National Regulatory Policy*, 74 Yale L. J. 1416 (1965)). For reasons mentioned, however, the demise of state protections of the three-tiered system will very likely generate greater diversity of distribution arrangements. A three-tiered system would survive where it generates efficiencies and suffer profit erosion where it fails to adjust to changed market conditions.

Such erosion of profits, however, by no means spells the demise of a three-tiered system. Amicus Daniel L. McFadden, one of the nation's leading experts on consumer markets (and an owner of a small winery), has argued that the distributors' investments in protecting their turf are disproportionate to the consumer benefits that would flow from a demise of artificial government protections of a three-tiered system. One reason why that might be so is that the broader availability of individualistic wines would tend to sharpen consumer awareness and appreciation. McFadden at 3. This analysis is consistent with the prediction that the demise of direct shipping restrictions will principally affect the selection rather than the price of wines. Put differently, expanding markets are not a zero-sum game.

One likely and salutary effect would occur "upstream," in wine production. Since one does not normally observe rapid market entry and increased market concentration at the same time, one can infer that the existing distribution bottleneck

> substantially contributes to the bifurcation of the market into large and increasingly concentrated producers at one end and small wineries that cater to tourists and Internet purchasers at the other end. Dale M. & Philip L. Martin, *Inside the Bottle: The Wine Business*, Choices 30, 33 (Fall 2002). A more flexible distribution system would likely contribute to a market structure that more accurately reflects market forces and efficiencies.

II. DISCRIMINATORY DIRECT SHIPPING RESTRICTIONS ERECT PROTECTIONIST BARRIERS THAT LACK A PLAUSIBLE JUSTIFICATION

A. The Nondiscrimination Principle of the dormant Commerce Clause Serves Compelling Economic Purposes

As noted, the petitioners and their *amici* fail to cite (let alone rebut) the FTC Report's finding that states have many less restrictive means than a direct shipment prohibition (especially a discriminatory prohibition) to protect legitimate tax and public health interests. Perhaps in recognition of the weakness of their position, several briefs on behalf of the petitioners argue for an overruling of Supreme Court precedents that require a tight means-ends relationship with respect to discriminatory state laws. *See, e.g.,* Brief for the Petitioners 28 ("Michigan respectfully submits that *Bacchus* was wrongly decided…"); Brief of Ohio and 32 Other States as *Amici Curiae* in Support of Petitioners 10–12 ("*Bacchus* was wrongly decided and should be overruled."); Brief of National Beer Wholesalers Association as *Amicus Curiae* in Support of Petitioners 15 n.10 ("*Bacchus* should at the least be confined to its unique facts and procedural history."). That extreme position should be rejected. The nondiscrimination principle of the dormant Commerce Clause serves compelling economic interests that would otherwise be unprotected.

To be sure, economic rents tend to dissipate, and there are reasons to believe that this is already happening in the wine distribution market. McFadden at 3. The relevant consideration, however, is the time horizon. One can argue, for example, that monopolies will inevitably disappear over time and that the only function of antitrust law is to shorten the time frame over which that result will occur. Frank H. Easterbrook, *The Limits of Antitrust*, 63 Tex. L. Rev. 1 (1984). But while that consideration counsels caution in extending legal norms to poorly understood contexts, the game is plainly worth the candle when we can be sure about the results of applying the basic rules to the easy cases. These cases, as explained to us, do not call for an extension of the dormant Commerce Clause; they confront the hard core of that doctrine with an openly discriminatory state violation. Reliance on long-term economic forces is no reason to repeal Section 1 of the Sherman Act or to suspend the operation of the dormant Commerce Clause in a paradigmatic discrimination case.

Nor is there any comfort in the observation that the costs of state prohibitions of direct wine shipments will in all events be paid by regulating states' own citizens. The ready answer is that this Court has steadfastly rejected, in cases involving discriminatory state regulation, the argument that the in-state incidence of the costs somehow exempt a discriminatory regime from Commerce Clause condemnation. *West Lynn Creamery v. Healy*, 512 U.S. 186, 203 (1994); *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, 271–73 (1984). For one thing, there are two sides to every interstate transaction, and the dormant Commerce Clause protects the out-of-state seller at least to the same extent as the in-state consumer. *H.P. Hood & Sons, Inc. v. Du Mond*, 336 U.S. 525, 539 (1949). See also *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263, 267 (1984) (out-of-state wholesalers have standing to challenge discriminatory tax exemption for in-state producers). For another thing, the incidence of a discriminatory tax or regulation does not necessarily match its form or stated range of application. This implies that from a strictly economic perspective, a formal nondiscrimination principle will be both under- and over-inclusive. However, economists agree that incidence analysis is a devilishly difficult and uncertain business for which courts are poorly equipped. Stephen F. Williams, *Severance Taxes and Federalism: The Role of the Supreme Court in Preserving a National Common Market for Energy Supplies*, 53 Colo. L. Rev. 281, 290–95 (1982). The true test of an efficient legal rule is not to get every case right but to reduce error costs in the general run of cases. The Court's nondiscrimination rule, which condemns discriminatory state laws irrespective of their economic incidence, satisfies that criterion.

B. Direct Shipping Restrictions Owe Their Continued Existence to Protectionist Interest Group Pressures Rather Than Considerations of Consumer Welfare

The three-tier system was constructed in the wake of the Twenty-first Amendment. Its principal purpose was to preclude the re-emergence of a "tied" system between producers and exclusive retailers. That system, it was widely believed, had before Prohibition induced excessive alcohol consumption and enabled organized crime to gain influence over alcohol distribution and sales. Even the best-constructed and most public-spirited regulatory system, however, may outlive its usefulness (for example, on account of technological change in the regulated industries) and, moreover, mutate into a means of protecting private rather than public interests. Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & Econ. 211 (1976); Richard A. Posner, *Theories of Economic*

Regulation, 5 Bell J. Econ. 335 (1974); George Stigler, *The Theory of Economic Regulation*, 2 Bell J. Econ. 3 (1971).

In the decades following the enactment of the Twenty-First Amendment, virtually all states adopted a three-tier system. Most states enacted direct shipment prohibitions to protect that system, but those restrictions played only a small role, as the technologies of those times rendered remote transactions between producers and consumers uneconomic. In 1986, however, California limited direct shipment to imports from states that would permit, on a reciprocal basis, the direct shipment of California wines to their citizen-consumers. The economic logic is not hard to fathom: by limiting direct shipment rights to reciprocity states, California—home to the nation's largest wine industry—sought to open other states' markets to its domestic producers.

California's move prompted a change from a relatively homogeneous state regulatory environment to the current patchwork of state alcohol regulation. Some states responded relatively quickly in the manner hoped for by California; there are now 13 reciprocity states. Many other states loosened their restrictions and allowed direct shipments from out-of-state, often under a permit system. A few states, however, Michigan among them, tightened their direct shipment regulations.

The fierce contention over direct interstate shipments, which has at last reached this Court, is driven by interest groups. On one side are wine consumers, allied with small wineries that seek to satisfy consumer demand for small-volume, high-end wines but are inhibited in that endeavor by the existing distribution system. (Large wineries, which fare perfectly well under the existing distribution system and some of which have succeeded in establishing their own national distribution networks, are sitting on the sidelines.) On the other side stands an unusual coalition. Bruce Yandle, *Bootleggers and Baptists: The Education of a Regulatory Economist*, Regulation 12 (May/June 1983). The wholesalers of alcoholic beverages have emerged as the nation's staunchest and most resourceful advocates of temperance. More traditional temperance forces, for their part, have complemented their moral arguments with a rigorous defense of the regulatory bottleneck and to that end joined forces with the alcohol wholesalers. This unlikely coalition enjoys the support of public sector interests—that is, state regulators and tax administrators.

These interest group alignments permit inferences both with respect to marketplace economics and with respect to the credibility of public-interest rationales to suppress competition. The interests that advocate a repeal of restrictions of direct interstate wine shipping (whether by legislative means or as a constitutional proposition) are by and large open about their economic self-interest, but they can buttress their position with arguments of consumer welfare. In contrast, the defenders of the existing distribution system have failed to defend their position on economic grounds, because no such grounds exist. They have instead relied on purported public interest rationales other than consumer welfare, some of which are diametrically opposed to their manifest economic interests.

The variegated state responses to California's unilateral adoption of a reciprocity regime in 1986 suggest an obvious question: why did formerly homogenous state regulatory regimes generate such disparate responses? Riekhof's and Sykuta's sophisticated analysis directly addresses that question and finds "that economic interests play a significant role in determining a state's adoption of direct shipment [regulations], but no evidence supporting a general public interest motivation." Riekhof & Sykuta at 4. That finding is highly plausible even at an intuitive level: "If direct shipment prohibitions prior to 1986 were in place solely for public interest reasons, it would be difficult to explain why California's decision to adopt reciprocity would have its intended effect of opening up access to no-shipment states." *Id.* at 12. Unsurprisingly, the authors find that the size of a state's wine industry (number of wineries relative to state wine consumption) is positively related to the adoption of reciprocity laws. Conversely, the size and concentration of the distributor industry are negatively correlated with the likelihood that reciprocity legislation will be enacted. *Id*. at 22. Riekhof & Sykuta found that public sector interests (such as tax collections) also affect state responses. In contrast, none of the authors' proxies for public interest considerations appeared to have a significant effect on state policy responses. *Id*. These results are highly consistent with well-accepted general economic theories of regulation. They directly affect the present case: "To the extent that public welfare interests are required by courts to justify states' restrictions on interstate commerce, our results cast a shadow of doubt on public interest arguments in the area of direct shipment of wine." *Id.* at 26.

C. The Constitutional Principle of Non-Discrimination, as Applied by This Court, is Supported by Sound Economic Reasoning

Every federal system (loosely speaking) confronts the challenge of reconciling open borders—a minimum condition of an integrated national market—with the preservation of the member-states' legitimate regulatory powers. A number of principles answer to the task—none of them perfectly, but some well enough. *See generally* Michael Trebilcock & Robert Howse, *A Cautious View of International Harmonization: Implications from Breton's Theory of Competitive Governments*, *in Competition & Structure: The Political Economy of Collective Decisions* 386 (Gianluigi Galeotti, Pierre Salmon, & Ronald Wintrobe eds., 2000).

As has been pointed out, the governing principle should be stated explicitly in the federal system's general charter. See Antonin Scalia, Chapter 16 in *Federalism in a Changing*

World: Learning from Each Other 539 (Raoul Blindenbacher & Arnold Koller eds., 2003) (explaining the advantages of the nondiscrimination rule for a European audience). But the need for a harmonizing principle is so strong that courts have felt compelled to infer it even where the governing instruments do not literally provide for it. The European Court of Justice, for example, has inferred from the European Treaties a principle of "mutual recognition," which (in the absence of countervailing regulations by the European Commission) compels member-states to open their markets to other EU countries' goods so long as those goods conform to the regulatory requirements of the origin state (rather than the destination state). *Rewe Zentrale v. Bundesmonopolverwaltung für Branntwein* (Cassis de Dijon), 120/78 [1979] ECR 649, [1979] 3 CMLR 494. This principle directly bars member-state regulations that discriminate against other member-countries' producers. It is enforced in part through a demanding "least restrictive means" test, which compels member-states to pursue regulatory objectives that have discriminatory effects by means that minimize those effects. *Commission v. Germany*, 178/84 [1987] ECR 1227, [1988] 1 CMLR 780; *Walter Rau v. de Smedt*, 261/81 [1982] ECR 3961, [1983] 2 CMLR 496.

A principal alternative—more respectful of state regulatory authority than mutual recognition—is the principle of nondiscrimination. As explained to us, this principle is embodied in this Court's decisions under the dormant Commerce Clause. Viewed through economists' eyes, this principle appears to serve important economic functions. First, it obviously represents a middle path between forced exclusion (which could Balkanize the economy) and forced entry by outsiders (which would eviscerate the states' police powers). Second, the principle serves as a vital safeguard against "naked" interest group transfers (or, as the Founders called it, "partial legislation") that serve no public purpose but merely transfer wealth—typically, from unorganized constituencies (such as consumers) to highly organized interests (such as liquor distributors). The presumption against such transfers pervades the entire Constitution. Cass Sunstein, *Naked Preferences and the Constitution*, 84 Colum. L. Rev. 1689 (1984).

A non-discrimination principle in interstate commerce provides no protection against purely in-state exploitation. But it need not do so: the principal protections come from the fact that citizens vote, both at the ballot box and with their feet (that is, by leaving states that give too wide a berth to interest group exploitation). Precisely for fear of those consequences, state-level factions will seek to impose the costs of their schemes on outsiders, by regulating on an extra-territorial basis or by enacting schemes that exempt in-state interests from burdensome tax or regulatory schemes. The dormant Commerce Clause rightly prohibits both stratagems. *See, respectively, Healy v. The Beer Institute*, 491 U.S. 324 (1989); *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984). In that fashion, the non-discrimination rule curbs the destructive force of faction on the decisive margin. *See generally* Saul Levmore, *Interstate Exploitation and Judicial Intervention*, 69 Va. L. Rev. 563 (1983) (arguing that the Supreme Court has employed the dormant Commerce Clause, and should continue to employ it, as a means of preventing interstate exploitation).

These elementary considerations apply with full force to the present context. Michigan may permit direct wine shipments (even while prohibiting direct shipments of liquor or beer), or it may prohibit such shipments for all market participants, in-state and out-of-state. What the state may not do, barring the strongest possible justification, is to discriminate against out-of-state parties. The economic justification for that rule, to repeat, is that such discrimination is a highly reliable signal for illicit interest group transfers. If a state is unwilling to impose the costs of some regulatory scheme on in-state producers (on a proportional basis), its proffered public interest rationales for the regulation are likely a pretext for redistribution. That presumption may be overcome only by an exceedingly persuasive showing that the geographic discrimination in fact corresponds to a pressing public purpose. *Maine v. Taylor*, 477 U.S. 131 (1986). Put differently, the nondiscrimination rule of the dormant Commerce Clause holds in-state interests hostage to the purpose of distinguishing bona fide public purposes from naked interest group transfers. While the burdened interest in a particular state will resent that fact in any given case, the rule works with perfect symmetry: the injunction against home-state preferences is the flipside of the more important right of nondiscriminatory access to other states' markets. Economic actors unaware of which economic position they would assume after a random assignment would therefore, if rational, choose a non-discrimination rule that limits opportunities for exploitation on all sides. *See generally,* Geoffrey Brennan & James M. Buchanan, *The Power to Tax* (1980). Accordingly, there is no obvious economic reason for recognizing opportunistic preferences in favor of discrimination adopted after the fact.

CONCLUSION

For the foregoing reasons, the decision of the Sixth Circuit should be affirmed.

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