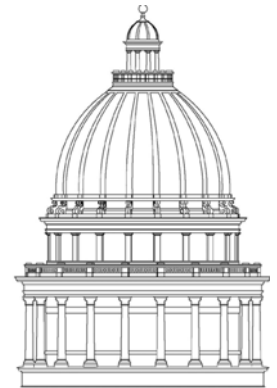


Office of the
LEGISLATIVE AUDITOR GENERAL
State of Utah

**REPORT NUMBER ILR 2010-B
May 2010**



A Limited Review of the Effects of DABC Budget Cuts on State Revenue

Our office completed a limited review of the revenue generated by the Department of Alcoholic Beverage Control (DABC) and the ramifications of recent cuts to the DABC's operating budget. There have been some questions about how the budget cuts of the 2010 Legislative General Session to the DABC's operating budget will affect state revenue. The DABC has proposed that the budget cuts will reduce the operating hours of 12-hour stores by two hours which, according to the DABC assumptions, will result in a 3.5 percent decrease in sales. Based on our review, we made the following observations:

- The overall effect of cuts to the DABC's operating budget on state revenue is unknown. The reported loss of revenue from these cuts is based on management assumptions.
- Alternatives for addressing these operating budget cuts have not been adequately considered by the DABC.

With the conclusion of this review, administrators for the DABC have agreed to revisit how the department is addressing the budget cuts to potentially offset the proposed reduction in the operating hours of the 12-hour stores. The concerns about the affects of

While the overall effect of budget cuts on state revenues is unknown, the DABC has not adequately considered other alternatives to address these cuts.

budgetary cuts on state revenue were raised following the April 2010 DABC Commission meeting. The DABC is governed by a five-member, part-time commission. In this commission meeting, it was reported that the state would lose around two million dollars as a result of recent budget cuts, and would also incur costs of \$120,000 for required additional signage on existing stores. This limited review was requested by the Legislature because of concerns about potential negative effects on state revenue.

DABC Will Not Incur Additional Costs For The Word “State” Added to Signage

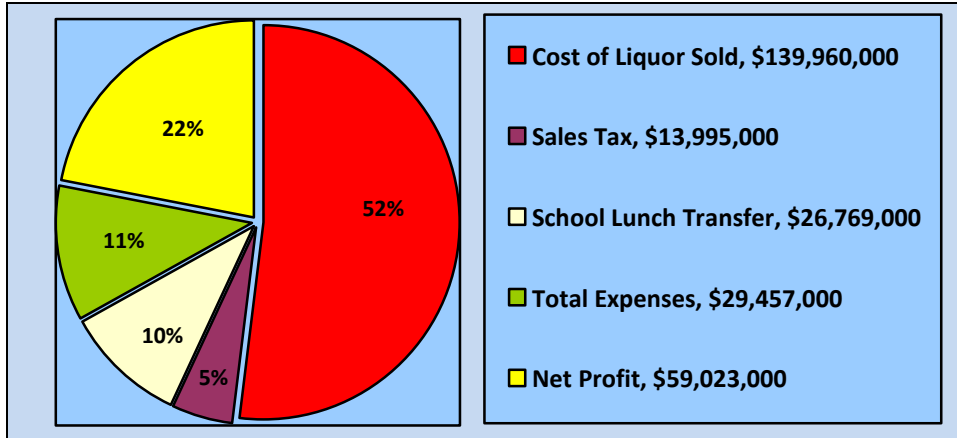
At the April 2010 DABC Commission meeting, commissioners criticized the Legislature for requiring the DABC to put the word “state” on all existing liquor stores for an estimated cost of \$120,000. This claim is false. The bill requiring the new wording had no fiscal note attached because it only requires the wording on new signage to be installed or replaced at or near a state store on or after May 11, 2010. The estimated cost was obtained by a phone bid which said that the cost would be \$20,000 per store and the DABC estimated that they would have to alter the signs at 6 state liquor stores. The \$120,000 cost was cited under the assumption that the DABC would have to alter existing signs, which is not required by the statute.

**The estimated
additional cost of
\$120,000 was
inaccurate.**

Liquor Sales Generate Significant State Revenue

The DABC generates significant amounts of revenue for the state through liquor sales. Figure 1 shows the distribution of dollars from the DABC operations for fiscal year 2009.

Figure 1 The DABC Distribution of Dollars for Fiscal Year 2009. Net profit, school lunch transfer, and sales tax become state revenue. Percentages listed are based on gross sales and fees totaling \$269,307,000.



Distribution of dollars for FY 2009 was taken from the 74th Annual Report of the DABC.

Liquor sales generate significant revenue because the DABC has a monopoly on liquor sales and products are marked up 86 percent.

School lunch transfer, which is monies generated from liquor sales transferred to the school lunch program, is statutorily required to be 10 percent of state liquor sales. Net profit, school lunch, and sales tax are all state revenues.

As previously mentioned, liquor sold by the DABC generates significant revenue for the state. The DABC is a state created monopoly, which means all controlled products are selected and sold by the DABC and statutorily marked up 86 percent. The regulation of liquor sales is not unique to Utah, according to the DABC:

Utah is one of 19 “control” jurisdictions in the nation that controls the sale of alcoholic beverages (there are 18 states and Montgomery County in Maryland). These jurisdictions, which regulate their own retail and/or wholesale distribution of alcoholic beverages, account for nearly one-third of the U.S. population.

The Effects of DABC Budget Cuts On State Revenue Are Uncertain

While the DABC does generate revenue for the state, the effects on revenue because of recent cuts to the DABC’s operating budget are unknown. The DABC assumes these cuts will result in a 3.5 percent

While the DABC saw an increase in their overall budget for FY 2011, operating costs were cut.

To address the budget cuts, DABC is looking at reducing the operating hours of all 12-hour stores by two hours.

reduction in sales, but this is only an assumption. During the 2010 Legislative General Session, the overall budget of the DABC was increased from about \$29 million to \$31 million. This increase was given to help the DABC address bond payments and operation and maintenance costs. While the DABC saw an increase in their overall budget, their operating budget was reduced by about \$653,000. To address this reduction, the DABC has considered taking the following actions:

- **A \$380,000 reduction in part-time store clerk hours.** As currently proposed by the DABC, this will result in a reduction of operating hours for all 12-hour stores by two hours. As assumed by the DABC, it is this reduction that may result in the predicted loss of state revenue, but they are able to offer no evidence to either support or refute this assumption.
- **A \$153,000 reduction in bonuses and incentives.** The Deputy Director for the DABC said that bonuses and incentives were eliminated.
- **A \$120,000 reduction in department expenditures.** The Director of Finance for the DABC believes that by reducing expenditures department-wide, the DABC can meet this budgetary reduction.

These three reductions will meet the required operating budget cut of \$653,000.

The \$380,000 reduction in part-time store clerk hours, as planned, will happen by opening the 12-hour stores one hour later and closing them one hour earlier. Eight-hour liquor stores will not be affected by this proposal. The DABC currently has 41 state liquor stores, 17 of which are/were 12-hour stores. By cutting part-time employee hours, the DABC has chosen their least expensive resource to fill the budget cuts. This option will affect the greatest amount of employees and hours.

Management for the DABC assumes these time cuts will result in reduced sales of 3.5 percent in the 12-hour stores (See Appendix). According to DABC administrators, “the sales for the two hours that

are proposed to be cut are 9.5 percent of total sales in 12-hour stores.” It is their opinion that customers buying habits will change, allowing them to keep 6 percent of the 9.5 percent. However, DABC management estimates that the remaining 3.5 percent of the 9.5 percent will be lost sales, resulting in a loss of state and local funding of over \$1.734 million dollars. The estimated lost revenue is as follows:

- Lost Profit: \$ 1,020,000
- Lost School Lunch: 510,000
- Lost Sales Tax: 204,000
- **Total Lost Funding:** \$ 1,734,000

When calculated, this amount assumes about a 4.6 to 1 ratio (\$1,734,000/\$380,000), which means every \$1 cut from the DABC operations results in a loss of \$4.60 in state revenue. In the April 2010 DABC Commission meeting, commissioners criticized this cut because of the effect, cited above, it will have on the state.

There is no evidence to support or refute the assumption that the state will lose 3.5 percent in sales. DABC management is assuming that because the stores will not be open as many hours, the state will lose those spur-of-the-moment sales that would have occurred during those two hours. The DABC has no documentation on the amount of sales that are spur-of-the-moment, or evidence to support their assumption that they would lose spur-of-the moment sales.

The DABC also stated that the effect of this budget reduction will probably not even be able to be measured in the future because sales will probably continue to increase, masking the true effect of this action. While the estimated 3.5 percent in lost sales is based only on an assumption, we believe that the DABC could address the budget reduction in other ways that would not require reducing the operating hours of 12-hour stores.

Alternatives to Reducing Store Hours Have Not Been Adequately Considered

Administrators for the DABC have not adequately investigated alternatives to addressing the budget cuts. Documentation obtained

There is no evidence to support or refute the assumption that the state will lose 3.5 percent in sales.

In addition to reducing store hours by cutting back on part-time employees, other alternatives exist for addressing the budget cuts.

from budget worksheets and management for the DABC have indicated that reducing hours at 12-hour stores and eliminating part-time employee hours are the primary options the DABC has considered in addressing the current budget needs. The problem with this approach, as mentioned previously, is that it uses the cheapest resource to address budget needs, but does not consider impact on revenue. DABC administrators have indicated that about 55 part-time employees would be affected by the cuts, but we believe that the DABC can address their budgetary needs without reducing hours at the 12-hour stores. This can be done by a mix of the following alternatives, among others:

- Closing a lower-performing eight-hour store when demand can be met by a nearby store
- Reducing the number of administrative and warehouse full-time employees
- Reducing the number of store full-time employees

We believe that these alternatives could better serve the needs of the public and could address the current budgetary needs of the DABC.

DABC May Want to Consider Closing a Store as an Alternative

An alternative that has not been adequately considered to reducing the operating hours of the 12-hour stores is the possibility of closing a store. We have identified several stores that could be closed that are very close in proximity to other stores that would remain open. It is anticipated that the shoppers at these stores would simply start shopping at the nearby store.

We have identified several state liquor stores that the DABC could consider closing. Closing just one of these stores would save the DABC annual operating costs of more than half of the proposed reduction of \$380,000. In St. George, a new 10,000-square-foot store was recently opened. This store is only 2.35 miles from the other state liquor store in St. George, which is only 4,740 square feet. Closing the smaller St. George store would reduce annual expenditures by between \$307,000 and \$356,000 per year. Other examples include:

The DABC has not adequately considered the possibility of closing a lower-performing store in close proximity to another state liquor store.

- The new regional store in Pleasant Grove that recently opened is only 2.08 miles away from the liquor store in Orem.
- The Salt Lake City Miller Avenue store is 2 miles away from the nearest store and 2.06 miles away from the next-nearest store, and it has a total of 14 liquor stores within 5 miles of it. While this store is still being covered by a state bond, the DABC could save on the annual costs of this store.
- The new regional store that is scheduled to be open in Springville will be close to the existing Provo liquor store.

Closing a state liquor store is a viable option that could potentially have little effect on overall sales for the state; this option has not been reasonably considered by the DABC.

Reducing the Number of Administrative and Warehouse Full-Time Employees

We found no evidence that the DABC seriously considered a reduction in any of the 42 administrative office full-time employees or the 31 warehouse full-time employees. Reducing any of the full-time employees in the administrative office or the warehouse could have the potential to eliminate the need to reduce store operating hours. However, administrators for the DABC reported to us that the number of full-time employees in the administrative office and the warehouse has not increased in the last seven years. In this time, the volume of liquor sold has nearly doubled and the number of licensees has increased.

Reducing a Mix of Full and Part-Time Employees

Reducing the hours of part-time employees only, has a greater affect on store operating hours if full-time employees are not also considered. Including full-time employees into the budget cuts could allow the 12-hour stores to remain open as currently scheduled. The current plan of DABC administrators will affect about 55 part-time employees through the elimination of positions and a reduction of hours. The problem with this approach is that it uses the cheapest

Reducing part-time employees uses the cheapest resource to address the budget cuts; the DABC should also look at reducing full-time employees.

possible resource to address the current budgetary needs, but affects the highest number of people, thus having a greater impact on store hours.

Part-time employees, on average, cost approximately \$9.60 per hour and work fewer hours than full-time employees. Based on the DABC's most recent management report, excluding store managers, the average full-time retail employee for the DABC makes approximately \$11.60 per hour. A calculation of the benefits shows that full-time employees cost significantly more than part-time employees. A full-time employee making \$11.60 per hour costs the DABC \$42,468 each year. The breakdown of the average hourly rate, with benefits, for a full-time retail employee for the DABC is shown in Figure 2.

Figure 2 Breakdown of the Average Cost for a Full-Time Retail Employee of the DABC. DABC full-time retail employees, on average, cost more than double the hourly rate of part-time employees.

Salary	\$ 24,221	<u>Regular Hours</u>
Employee Benefits	7,792	\$ 42,468 / 2,088 = \$ 20.34
Medical	9,747	<u>Productive Hours</u>
Dental	667	\$ 42,468 / 1,834 = \$ 23.16
Life Insurance	41	<i>Note: Productive Hours reduce the annual hours of 2,088 by 254 hours to account for 104 hours annual, 60 hours sick and 90 hours holiday.</i>
Total	\$ 42,468	

Salary costs are \$11.60 per hour multiplied by 2,088 hours per year. Employee benefits are the state rate for retirement, unemployment compensation, workers compensation, social security and Medicare, vacation/sick leave termination pool and post-employment benefits pool. Medical and dental was estimated at the double rate because DABC employees were evenly distributed among family, double, and single rates. Life insurance is the current state rate per employee.

As Figure 2 shows, the hourly rate of a full time employee with benefits is \$20.34. Controlling for unproductive hours, such as annual, sick, and holiday, we determined that full-time employee costs are \$23.16 per hour. Part-time employees were calculated at \$9.60 per hour. Therefore, hourly costs for a full-time employee are more than twice those of a part-time employee.

According to the DABC, using part-time employees to address the budget cuts will result in a reduction of 39,520 store clerk hours. If

full-time employees were used, store clerk hours would only have to be reduced 16,408 hours. Using full-time employees as part of the budget cuts would result in a savings of about 23,112 store clerk hours per year. Currently, the DABC has 17 full-time vacancies in their liquor stores. The DABC could consider not filling these positions as part of a plan to address the budget reductions. By including full-time employees in the budget cuts, the DABC could potentially keep stores open during their scheduled times, or possibly limit the reduction in operating hours of 12-hour stores.

Using full-time employees as part of the budget cuts saves about 23,112 store clerk hours per year.

Recommendation

1. We recommend that the DABC Commission consider all alternatives to budgetary cuts.

Appendix

**UTAH DEPARTMENT OF ALCOHOLIC BEVERAGE
CONTROL
MEMORANDUM**

TO: Brian Dean, Legislative Auditor

FROM: Leonard J. Langford, Finance Director

DATE: May 12, 2010

SUBJECT: Effect of Budget Cuts on DABC

We have revised our previous analysis of the effect of the budget cuts. As we look at the store sales by hour, we find that the sales for the 2 hours that are proposed to be cut are 9.5% of total sales in 12 hour stores. With the loss of store hours, we would expect to lose a portion of those sales, but not all of them.

It is management's opinion that 6.0% of the 9.5% will be kept as customers change their buying habits and adjust to the reduced store hours. However, management estimates that we will lose 3.5% of the 9.5% of the sales for the cut hours. We believe that this loss of sales will result in a loss of funding to the State and local governments of over \$1.734 million dollars. This loss is calculated as follows:

Sales Reductions

Total FY 2009 sales for DABC State of Utah	\$ 267,123,000
Total FY 2009 Store sales in 12 hour stores	\$ 145,836,000
Percentage of lost sales	<u>3.5%</u>
Lost Sales in 12 hour stores	<u>\$ 5,104,000</u>

Lost Profit, School Lunch & Sales Tax

Lost Profit (using 20% profit margin)	1,020,000
Lost School Lunch (10% of lost sales)	510,000
Lost Sales Tax (using 4% due to non-taxable licensee sales)	<u>204,000</u>
TOTAL LOST FUNDING	<u>\$ 1,734,000</u>

We believe that the above calculation is reasonable and conservative.