Should We Top Up the Winemaker's Cup?

"My only regret in life is that I did not drink more Champagne."
- John Maynard Keynes

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Mention wine to most folks and Connecticut hardly jumps to mind. California clearly dominates U.S. wine production—perhaps more than commonly thought—but other states, including Connecticut, are finding their niches in the wine industry. The trend seems likely to continue, but could the state speed the process along without imposing higher costs on other businesses and state residents or, better yet, institute programs that simultaneously benefit other sectors of the state's economy? Some basic economic concepts can illuminate these issues and the potential costs and benefits of encouraging Connecticut vineyards to expand.

Commercial winemaking in Connecticut dates back to the mid-1970s, with the founding of Litchfield County's Haight-Brown Vineyard. Since then, winemaking has flourished in a state better known for selling wooden Nutmegs and nuclear submarines than vintage varietals. The Connecticut Wine Trail (http://www.ctwine.com/)—the Connecticut Vineyard and Winery Association's program to promote winemaking and wine tourism—includes 23 of the state's 30 or so wineries, with an array of shops, tours, and tasting rooms.

Connecticut has company in promoting winemaking in the Northeast. New York, ranking 2nd to California in wine production, has long touted the virtues of Long Island and its Finger Lakes District; and even milk-laden Vermont pushes a little of the gods' nectar on those who primarily come to ski, fish, and sample the cheese. Some ridicule the region's "boutique" wineries, but catering to visitors and special segments of the regional wine market may not be such a bad strategy for area wineries or the state. The fact that the number of U.S. wineries jumped from under 3,000 in year 2000 to more than 6,000 today may be a strong signal that other states are already enacting policies to encourage growth of the industry.

ALL FOR WINE, WINE FOR...

All 50 states—even Alaska—produce wine, but when it comes to market share, California is in its own league. The chart on the next page tracks the wine production of the U.S. (green) and California (gold), measured on the left vertical axis, as well as California's percentage share (black) of national output, on the right vertical axis. America's wine output rose from 437 million gallons in 1995 to 707 million gallons in 2009, a 62% increase or about 3.5% per year. But the vagaries of wine production make for a bumpy growth path. Unusually good or bad harvests, changing tastes, cropland adjustments, general economic conditions, and foreign competition combine to produce a wine cycle. But, given its large share—roughly 90%—of total output, it's no surprise that fluctuations in California's output drive the U.S. pattern, and that its average annual rate of growth (3.4%) is almost the same as for the nation.

Because California's output share—the black line—has drifted downward slightly, from 90.8% in 1995 to 89.3% in 2009, the combined output of all other states has grown at a steadier and somewhat more rapid annual rate of 4.6%. But even if this differential rate of growth persisted for the next 20 years, California would still produce 87% of U.S. wine. Global climate change or a serious earthquake might be the only events that would dethrone the nation's premier wine producer.

BUILDING THE BASE

Building an economy on wine production is probably ill advised anyway…just ask the French. Even in California, grape production and winemaking are but part of a much larger agribusiness sector, which in turn is dwarfed by the tech sector, skilled manufacturing and, until recently, homebuilding. But California vintners are pretty successful and clearly contribute to the economy, in part because producing and selling wine is only a portion of their business.

California vineyards have diversified—a visit to nearly any West Coast tasting room reveals a variety of products and gifts, ranging from wine paraphernalia to gourmet foods, colorful T-shirts and glossy postcards. But many vineyards also use this initial contact with the "wine tourist" to establish an ongoing commercial relationship that includes Internet or mail order sales, special offers and wine clubs, word-of-mouth advertising to other potential customers, and (hopefully) repeat visits. Finally, while wholesale transactions still account for much of the vintner's total sales, opportunities to sell by the bottle or case directly to consumers at market prices and to charge for meager tasting-room samples (they used to be larger and free!) offer a welcome source of cash.

But the potential benefits of wine tourism are not limited to those who produce and sell the wine. Others also have an economic stake in the process. Regional economists have long recognized the important role that net exports—exports less imports—play in determining an area's level of economic activity and income. We normally think of exports as the sale of goods or services to other countries, but the same concept applies to regions, states, or even cities. And whether the item is a tangible good or service sold to an outside party, or a local purchase by a non-resident, the effect is much the same: the income received generates

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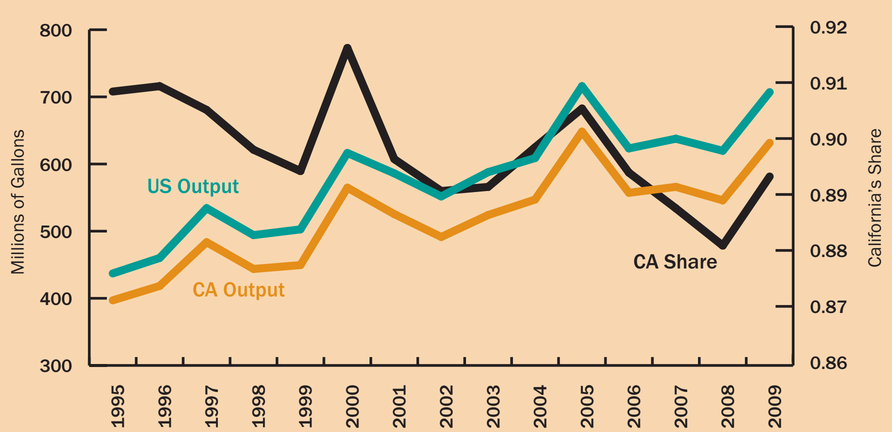
CALIFORNIA'S LARGE SHARE DECLINING…BUT ONLY A BIT



SOURCE: *The Connecticut Economy*, based on data from The Wine Institute

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further economic activity within the geographic area if a portion is re-spent locally. The higher the rate of re-spending in the local area (or state) by businesses, their employees and other input suppliers, the larger the impact of the initial "export" on the local economy.

This "multiplier effect" is attenuated if the sales income is re-spent on "imports" from other areas or states, or taxed away by various layers of government. Of course, some of the beneficial effect is regained if the government spends some of its tax revenue locally. "Economic base" models and other variants of this distinctly Keynesian view of the economy emphasize the importance of an area's exports and the propensity to recycle this revenue within the target economy as key determinants of economic growth.

WINE SPILLOVERS

So flogging wine to outsiders can boost an area's economy, but that holds for nearly any good. What is it about wine that might warrant a public effort to promote its production within this or any other state? First, as industries go, it's relatively clean. Any agricultural activity involves waste products, but compared with many other uses of farmland, growing grapes and producing wine are relatively green and consistent with state efforts to promote environmentally sound activities.

Second, Connecticut has long promoted farmland preservation, primarily through a purchase of development rights (PDR) program. Under this program, farmers are paid to permanently forego the future right to convert their land to nonagricultural uses, and these restrictions also apply to subsequent purchasers of the land. One criticism of PDR programs is that they fail to ensure public access to the preserved areas. But, knowing that guests can add to their sales and help promote their products to other consumers, most wineries welcome public visits that often include tours of the vineyard and production facilities. Thus, policies that encourage wine production might also preserve or even expand agricultural land without greatly limiting public access or permanently locking land into a fixed use.

Finally, supporting wine production may benefit other segments of the economy, especially food, lodging, and entertainment. Connecticut's "Wine Trail" program primarily seeks to attract visitors to member wineries, but it also offers information about local B&Bs, hotels and eateries, as well as wine-oriented events like the Connecticut Wine Festival or special attractions at individual vineyards. Connecticut has lots of company in promoting wine tourism. Nearly half the states have one or more wine trails (http://www.winetrailsusa.com/)—informal evidence of the spillover benefits of wine production.

FINDING THE RIGHT LEVER

The presence of positive spillover benefits or "external economies" is commonly cited as a key reason for government intervention. Without such involvement, firms—in this case, winemakers—will under-produce from a social perspective because their private decisions, designed to maximize their own profits or fulfill their particular goals, will not fully incorporate the beneficial side-effects of their activity on other parties—those local shops and B&Bs, for example. Under these circumstances, governments can and do use a variety of "carrots" to induce more of the beneficial activity.

Consider, for example, Connecticut's film tax-credit, adopted in 2006. A collection of tax incentives designed to lure movie production to the state, the program allows the filmmaker to offset Connecticut tax liabilities. Connecticut is not alone in its effort to grab the limelight: many states have similar tax-credit programs or other inducements for filmmakers. But the film tax-credit has been criticized on several grounds.

First, beneficiaries with limited in-state tax liabilities have been allowed to sell their credits to other firms willing to pay less than a dollar to reduce their tax bill by a buck. This transfer may reduce the state's tax take from other sectors that purchase the discounted credits, but without it, the intended impact—to increase film production—may be curtailed. And even if the tax-credit reduces the state's tax take from some sectors, it could still benefit the state if the additional filming produces large enough ripple effects in other parts of the economy.

Another criticism of the film tax-credits is that they may have limited impacts on local employment and spending. If actors and film crews are mostly non-locals, much of the spending generated by the incentive simply flows back out of the state. Some spending occurs on-location, but the transitory nature of film production also limits the long-run effect.

Finally, as suggested in the Summer 2008 issue of the Quarterly by DECD Managing Economist Stan McMillen, the proliferation of such programs across revenue-hungry states could simply amount to a zero-sum game, unless the programs promote overall growth in the film industry or attract foreign filmmakers who previously shot films abroad.

In some respects, a tax-credit to wineries might be easier to justify than a movie tax-credit. Unlike the filmmakers, most of our wineries are homegrown enterprises that (literally) have roots in Connecticut. To the extent that they rely on local workers and suppliers, and encourage complementary tourist activities that also use local inputs but draw revenue from outside the state, the multiplier effects could be stronger for wine tax-credits than for film tax-credits. Also, since wineries vary in their use of Connecticut grapes, a scaled tax-credit might be used to encourage the use of homegrown produce, further increasing the industry multiplier.

The problem, of course, with any policy that extends special treatment to certain industries or enterprises is clear: Where should the line be drawn? Why not offer similar inducements, on similar economic grounds, to hotels or local purveyors of food and entertainment, which also generate local income by catering to tourists?

THE WRATH OF GRAPES?

Not everyone believes we ought to encourage winemaking, regardless of how picturesque the properties might be, and the earlier externality argument easily cuts both ways. If more wine production would generate large social costs (alcoholism, health problems, road injuries and fatalities, etc.), it might be prudent for government to discourage the activity that produces the negative spillovers. This would call for public policy "sticks" rather than carrots, such as a discriminatory tax on wine production. Of course we already have such taxes on alcohol production and sales, in part because of this argument, but also because the lack of price-sensitivity in the demand for alcohol makes it a ripe target for taxes that sellers can readily pass forward to consumers in the form of higher prices.

Economists are often justly accused of waffling on matters of public policy, but economics offers no neat or simple answers to the question of whether certain industries or activities merit special treatment from the public sector. There are sound arguments for and against targeted economic policies, both on equity grounds and for reasons of economic efficiency, but often the "correct" answer depends on value judgments as much as the particulars of the market. What economics does make clear is that any public policy generates costs and benefits—private and social—that need to be weighed by policymakers. The tougher question, left to the political scientists, is how that scale gets calibrated and who has the heaviest thumb on it.

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