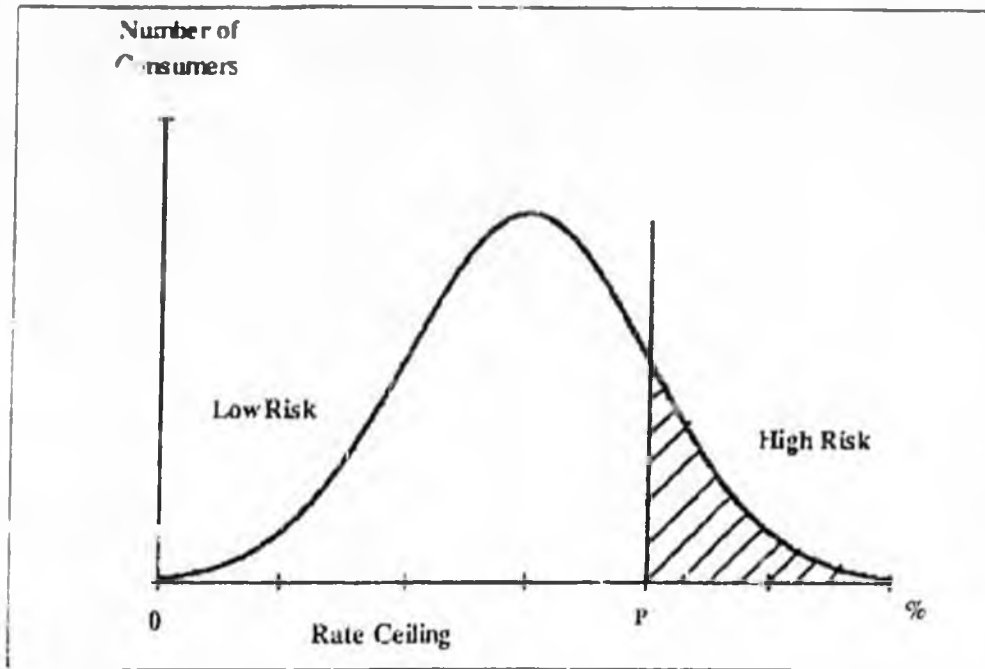


ALASKA LEGISLATURE COMMITTEE FILES, 2000-2000 86/2
11535 HOUSE LABOR & COMMERCE

Exhibit 19
Effect of Rate Ceiling on Availability of Cash Credit to Consumers



Why is this so? The higher the risk posed by credit applicants, the higher the costs to creditors of granting them credit. High-risk accounts typically breed above-average collection costs and, ultimately, higher credit losses. Experience varies among banks, credit unions and finance companies, but it generally takes eight to ten good accounts to offset the losses on one bad account. If the government does not permit lenders in the private sector to charge a rate high enough to cover these costs, financial institutions will not lend to consumers who would generate these costs.

As indicated earlier, the impact of rate ceilings has been so widely accepted that few empirical studies have been conducted on the issue in the past decade. Fortunately, basic economic principles and data do not wither with age. In a very large national study of loans made by commercial and savings banks, the National Commission on Consumer Finance in 1971 found that in 16 states with high rate ceilings, the dollars of loans per family were 21 percent higher than in the 16 states with low rate ceilings (Exhibit 20).⁴² The data indicate that consumers who were creditworthy in the high ceiling states would not have received legal cash loans in the low ceiling states.

⁴² *Consumer Credit in the United States*, pp. 134-35

Exhibit 20
Bank Personal Loans, Second Quarter 1971

	Number of Loans per 100 Families	Dollars of Loans per Family
Low-ceiling states	3.66	37.02
High-ceiling states	4.53	44.82

Source: National Commission on Consumer Finance, *Consumer Credit in the United States*, 1972, pp. 134-35.

A rate ceiling not only rations high-risk consumers out of the market, but also tends to ration out consumers seeking small amounts of credit. In addition to the costs associated with credit risk, there are administrative costs in granting credit and managing subsequent collections. Since many of these costs are fixed and unrelated to the amount of credit generated, they are proportionately higher for small amounts of credit. If these costs are not covered by the permitted finance charge, credit will not be extended, even to low-risk consumers.

A simple example illustrates the point. Assume that a hair dryer might be purchased for cash for \$20. Alternatively, it may be purchased for \$2.00 down and \$2.00 per week for ten weeks: total cost equals \$22, of which \$2.00 is the finance charge. Would a 20 percent cap on finance charges permit the transaction? Hardly, the annual percentage rate on that credit transaction is 102 percent. Yet, the \$2 charge imposed by the creditor does not seem unreasonable considering the cost of setting up the credit arrangement and processing 10 payments. It is reasonable to believe that high-risk consumers are often those who, at best, can afford to borrow only small amounts.

The effects on the market and consumers of imposing restrictive rate ceilings on small loans to high-risk borrowers are dramatically illustrated by the experience in Massachusetts. In 1977, in an effort to "protect" consumers the state legislature sharply cut rates that consumer finance companies were permitted to charge, especially on loans of less than \$2,500. Far from protecting consumers who needed to borrow only small amounts of money, the lowered rate ceilings caused lenders to shift away from offering those smaller loans into larger loans which were often collateralized by borrowers' homes, an option not available to less affluent renters. Comparison of their lending activity in 1975 and 1979 shows that:

the number of loans made below \$500 declined by 32 percent, and the large, national finance companies dramatically increased their investment in large second mortgage loans. At the same time the industry structure changed. The number of loan offices fell by 35 percent, with the small, local companies bearing most of the brunt of the decline in loans made and loans outstanding.⁴³

Even when consumers have been rationed out of the market by government price-fixing, they may still want to borrow money. Evidence of the strength of their demand is illustrated by Arkansas, where only a few

⁴³ Robert W. Johnson and A. Charlene Sullivan, *Restrictive Effects of Rate Ceilings on Consumer Choice: The Massachusetts Experience*. Working Paper No. 25. West Lafayette, IN: Credit Research Center, Purdue University, 1980, p. ii.

finance companies operate under a punitive rate ceiling. Law students who interviewed lenders in that state reported that finance companies did not advertise extensively because the expense was not warranted. One lender complained that "an advertising campaign draws borrowers like flies." However, 90 percent of those attracted were rejected because they could not be served under the rate ceiling. In other states, the rejection rate was around 50 percent. The researchers concluded, "This comparison indicated that a large segment of the Little Rock population is not regularly served by potential sources of small loans."⁴⁴

What do we know about these high-risk consumers that are excluded from the cash market by government fiat? Credit-scoring systems provide very good clues to the nature of consumers representing above-average risk. They are primarily consumers who are young, have a short time-on-the job or at their residence, rent homes, and are relatively unskilled workers. They are also likely to have lower incomes than more creditworthy consumers. The adverse effects of rate ceilings on low-income consumers has been documented in a study based on household financial data obtained from the 1983 Survey of Consumers' Finances. In that study, Villegas (1989) segmented respondents into three groups according to household income (high, medium and low) and tested how much credit they were able to obtain in states with and without rate ceilings. He concluded that "on average a low-income household residing in a state with usury ceilings had \$1,012 less consumer credit than an identical household in a state without usury ceilings."⁴⁵ In contrast, those consumers classified as having high-incomes were unaffected by the rate ceiling.

Confirming evidence is provided in the area of bank credit cards. A bank that is being squeezed between rising costs and a rate ceiling will attempt to reduce its credit risks. If it is using a credit-scoring system, it will raise the "hurdle rate" or "cutoff point" associated with acceptance. Using a bank's credit scoring system, Shay and Dunkelberg (1975) demonstrated the differences in rejection rates by income groups if the bank raised its cutoff point.⁴⁶

⁴⁴ "An Empirical Study of the Arkansas Usury Law: 'With Friends Like That...'" *Law Forum* (1968), pp. 580-81.

⁴⁵ Villegas, *op. cit.*, 136.

⁴⁶ Robert P. Shay and William C. Dunkelberg, *Retail Store Credit Card Use in New York*. New York: Graduate School of Business, Columbia University, 1975, p. 55.

Exhibit 21
Simulated Rejections of Holders of Bank Credit Cards
by Credit Score Cutoff Points

Cutoff Raised from 19 to:	% of Cardholders Who would be Rejected	Percent of rejected cardholders with incomes:			
		<\$7,500	<\$10,000	<\$15,000	<\$20,000
24	1.6	89%	89%	100%	100%
29	6.6	50	58	82	91
34	18.4	30	55	77	89
39	36.3	19	42	68	87
Percent of total sample of cardholders		8.9	17.3	42.0	68.4

Source: Shay and Dunkelberg, *Retail Store Credit Card Use in New York*, 1975, p. 55.

The results shown in Exhibit 21 are dramatic and consistent with theory. Raising the hurdle rate from 19 to 24 would have eliminated about two percent of the cardholders. However, 89 percent of those rejected had incomes less than \$10,000, the median income at that time. Since only 17 percent of all of the cardholders had incomes of less than \$10,000, tightened credit standards clearly would have had a disproportionate effect on low-income consumers.

Just because consumers have low incomes and need small amounts of credit does not mean that they should not have credit. Important insight into the needs of high-risk consumers who want small cash loans is provided by an extensive study of the small loan industry in Texas by Durkin (1972). At the time of his study the maximum loan that could be made by these high-rate lenders licensed under Article 3.16 of Texas statutes was \$100, with permitted rates ranging from 108.75 percent for \$100 loans for six months to 240 percent for a one-month loan of \$30 or less. Only 4.1 percent of the loans surveyed were for \$30 or less.

Why did these consumers borrow such small sums? Interviews revealed a wide range of needs that were met: old bills, debt consolidation, medical expenses, autos (purchase, parts, or repair), clothing, food, utility bills, house payments or improvements, family aid, taxes or insurance, and so on. Four-fifths of the borrowers knew that their loans were more expensive than bank loans, but these were generally not available to them.

What were the borrowers like? Given their needs, should they have been rationed out of the legal market by lower rate ceilings?

... most of them belong to the parts of the population that often have trouble obtaining credit. Over 36 percent of the borrowers sampled were unmarried, including over 14 percent who were separated or divorced and almost 9 percent who were widowed. The large majority of small small loan borrowers in

the sample were employed at low level unskilled jobs and most had incomes well below the median for the city where they lived. Over 15 percent of the borrowers were living on pensions or social security.⁴⁷

2. Reduction in competition

Since there are some fixed costs in lending to consumers (e.g. computers, development of sophisticated credit-evaluation systems), large lenders may have some competitive advantages over their smaller competitors. In a study for the National Commission, Benston (1972) found that large finance companies were more profitable than smaller firms, although there did not appear to be economies of scale in their operating expenses. However, there were economies of scale for large offices vs. small loan offices.⁴⁸

If there is an advantage to being "big," whether by firm or by lending office, large firms making cash loans are better able to survive under restrictive rate ceilings than their smaller competitors. Evidence is provided by the study of the effect of cutting rate ceilings in Massachusetts. The legislation not only made it more difficult for high-risk consumers to obtain a loan, but it also reduced the accessibility of loans by fostering a reduction in the number of loan offices from 266 to 172 over the period studied.⁴⁹ While individual consumers must usually obtain cash loans from local markets--now under-served as a result of the reduction in rate ceilings--lenders are free to move their funds globally to their most profitable use. Obviously, lenders in Massachusetts did just that, shifting their funds into other states and into second-mortgage loans to homeowners within the state. The least affluent and least creditworthy citizens found loan offices both less conveniently located and less likely to grant credit.

3. Evasive tactics

When the government intervenes between consumers who willingly borrow and lenders who willingly lend, both parties try to work around the impediments placed in their way by the legislature. This is neither cynical or illegal. It is simply the market at work. Unfortunately, evasion imposes additional costs on consumers and not necessarily the consumers who are borrowing. Evasion also imposes costs on society as a whole. Just as any road detour requires extra time and gas, so does a detour that consumers take to obtain cash credit create extra costs that are not productive for society in any sense.

a. Increase in other charges to consumers. The diverse impact on consumers of rate ceilings on cash credit is illustrated by data from a four-state study conducted in early 1979 by the Credit Research Center at Purdue University under a grant from the National Science Foundation. The study permits comparison of lenders' reactions to ten percent rate ceilings in Arkansas with states having much higher rate ceilings: Louisiana, Illinois and Wisconsin. Commercial banks in Arkansas evidently used various means, including raising fees on other bank services, to offset their mandated loss of revenues from loans to consumers.

⁴⁷ Thomas A. Durkin, "A High Rate Market for Consumer Loans: The Small Small Loan industry in Texas," *Technical Studies, Volume II*. Washington, D.C.: National Commission on Consumer Finance, 1972, p. 89.

⁴⁸ George J. Benston, "The Costs to Consumer Finance Companies of Extending Consumer Credit," in *Technical Studies, Volume II*. Washington, D.C.: National Commission on Consumer Finance, 1972.

⁴⁹ Johnson and Sullivan, *op. cit.*, p. 14.

Significant differences between the charges of Arkansas banks and banks in the other three states were found by Peterson and Falls (Exhibit 22).⁵⁰

A study by Sullivan of the same database found that, in relation to banks in the three control states, "banks in the Arkansas area were open to provide consumer services fewer hours per week." They also appeared somewhat less likely than banks in other states to provide ATMs to their customers.⁵¹

b. *Resort to sales or lease credit.* As will be seen in the following section, credit sellers can readily avoid rate ceilings merely by increasing the cash prices of their goods and services. Consequently, when consumers are unable to obtain small cash loans to shop for autos or household goods, then can go directly to sellers of goods and services and obtain financing through them. This practice is, however, a second-best choice for consumers. A consumer who finds a dealer willing to extend credit is "locked in" to the products sold by that dealer. Unable to obtain cash loans, consumers also resort to rent-to-own suppliers to obtain TVs and other household equipment. A perusal of the phone book in Little Rock reveals many such suppliers.

Exhibit 22
Significant* Differences in Credit Terms at
Arkansas Commercial Banks and Those in Three Control
States
(Mean values)

	Arkansas	Other	t-Values
Credit investigation fees (mortgages)	\$23.33	\$11.57	2.83
Bank check charges on minimum balance:			
0-99 dollars	\$4.21	\$0.77	5.43
100-199 dollars	\$3.10	\$1.90	1.96
200-299 dollars	\$1.74	\$1.06	1.99
300+ dollars	\$0.80	\$0.00	2.35
Check overdraft charges	\$6.21	\$4.81	1.97
Minimum personal loan size	\$1,571.52	\$579.94	8.24
Cosigners on most recent loan:			
Family auto purchase	12.7%	6.7%	6.44
Personal loan	13.0%	8.0%	2.82
Average maturity on auto loan (first car)	37.4 mo.	39.1 mo.	2.27
Percent of banks making 48-mo. auto loans	42.9%	87.5%	3.89

*Significant at 10 percent confidence level

Source: Peterson and Falls, *Impact of Ten Percent Usury Ceiling*, 1981, pp. 11, 16-17.

⁵⁰ Richard L. Peterson and Gregory A. Falls, *Impact of a Ten Percent Usury Ceiling: Empirical Evidence*. Working Paper No. 40. W. Lafayette, IN: Credit Research Center, Purdue University, 1981, pp. 11, 16-17.

⁵¹ A. Charlene Sullivan, *Evidence of the Effect of Restrictive Loan Rate Ceilings on Prices of Consumer Financial Services*. Working Paper No. 36. W. Lafayette, IN: Credit Research Center, Purdue University, 1980, pp. 12-13.

C. Resort to high-cost sources of cash credit. When high-risk consumers are denied cash loans by finance companies, banks or credit unions, they turn to both legitimate and illegitimate sources of credit. Some consumers will buy marketable goods, such as TVs, and then sell them for cash. Obviously, the cost of credit with that arrangement is considerably higher than would be the case were more established sources of cash credit permitted to operate.

An alternative source of cash credit is pawn shops, which are attracted to states where rate ceilings on consumer loans have curtailed the ability of potential competitors to make small, high-risk loans, while permitting pawnshops that privilege. For example, a study comparing the similar cities of Little Rock, AR and Champaign-Urbana, IL found that the former city had four pawn shops, while the latter had only two.⁵²

d. Resort to illegal lenders. Finally, consumers who are unable to detour to legitimate sources of cash credit may, in desperation, turn to illegal lenders. The rates that these consumers pay has been described by John M. Seidl in testimony before the U.S. House Subcommittee on Consumer Affairs:

The rate in some urban areas for small loans is 20 percent per week--"6 for 5." The interest charge--called "vig," "vigorish," or "juice" by borrowers and lenders alike--is due each week as long as the principal is outstanding. The principal can be reduced only by lump-sum or, in some cases, half-lump-sum payments. Since Truth-in-Lending requires statement of interest rates in percent per annum, it will be apparent that 20 percent per week is 1,040 percent per annum.

In other urban areas the rate is 20 percent for a six week or ten week period with interest charges added to the principal and the total repaid in equal weekly installments ... Twenty percent add-on for a six to ten week period produces from approximately 200 percent to 350 percent per annum.⁵³

B. Sales credit

Assume that an amusement park has a large number of hot dog stands, all competing vigorously with each other for sales. The Commissioner of the amusement park decides that some consumers find it difficult to buy hot dogs at the going price of 50 cents each and decrees that, to protect these consumers, the price charged for a hot dog may not exceed 40 cents. Query: what will happen to the prices charged for the bun and mustard?

Just as the forced reduction in the selling price of the hot dog generates a higher price for the bun and mustard, so does a legislated reduction in the finance charge on sales credit get transmitted into a higher price for the goods or services sold on credit. There is abundant evidence of "padding" cash selling prices in order to produce a lower rate of finance charge (annual percentage rate). A study by the Federal Trade Commission of credit and sales practices in the District of Columbia showed that the average rates charged low-income consumers buying goods and services on credit in the inner city was only four percentage points higher than the rates charged by general market retailers. On a \$100 purchase, that difference would amount to about \$2 on a 12-month contract. The costs of the higher risk and the typically small amounts financed appeared in the differences in the cash prices of the goods sold on credit. The average price of a television

⁵² "An Empirical Study of the Arkansas Usury Law," *op. cit.*, p. 580.

⁵³ *Hearings on Consumer Credit Regulations Before the Subcommittee on Consumer Affairs of the House Banking and Currency Committee*, 91st Cong., 1st Sess., pt. 1, at 185 (1969).

set with a wholesale price of \$100 was \$187 at low-income retailers, compared with \$131 at an appliance store serving the general market.⁵⁴ Lowering the rate ceiling on sales credit would merely have generated an even higher cash-price differential between the inner city purchase and one from retailers serving the general market.

Another basic study was done in Arkansas to test the theory that below-market rate ceilings would force credit sellers, such as department stores and appliance dealers, to inflate the cash price. The packing of the cash price would occur regardless of whether the credit seller offered installment sales or issued a retail credit card. Lynch (1968) compared cash prices of identical merchandise in Arkansas and seven other "control" states in the region that did not have low rate ceilings on sales credit. His findings were summarized by a composite price index representing prices on color television, dryers, kitchen ranges, refrigerators and washers, with the composite price in Arkansas set at \$100 for purpose of comparison. The data show very clearly that cash buyers in Arkansas paid significantly higher prices than cash buyers in the control states. (Exhibit 23)⁵⁵ Those findings are consistent with the theory that the higher cash prices were needed in order to subsidize the use of credit.

Exhibit 23
Composite Price Index for Major Appliances
Little Rock, AR = 100

Little Rock, Arkansas	\$100.0
Texarkana, Texas-Arkansas	95.88
Monroe, Louisiana	96.43
Greenville, Mississippi	96.66
Memphis, Tennessee	92.60
Springfield, Missouri	97.05
Tulsa, Oklahoma	93.09
Denver, Colorado	96.72

Source: Lynch, "Consumer Credit at Ten Percent Simple: The Arkansas Case," 1968, p. 599.

Rate ceilings on sales credit clearly do not "protect" credit buyers. Moreover, they force cash buyers, who may not be sufficiently creditworthy to obtain credit, to subsidize other consumers who have been able to obtain credit. Thus, rate ceilings "heap distress," even upon innocent cash buyers.

Whether issuers of bank credit cards, as contrasted to retail credit cards, cause part of the cost of credit to be pushed into cash prices depends on whether the bank issuing the card is out-of-state or in-state. If a national, out-of-state bank has issued a credit card to a resident of a state with restrictive rate ceilings,

⁵⁴ Federal Trade Commission, *Economic Report on Installment Credit and Retail Sales Practices of District of Columbia Retailers* (1968).

⁵⁵ Gene C. Lynch, "Consumer Credit at Ten Per Cent Simple: the Arkansas Case," *Law Forum* (1968), p. 599.

that bank is free to "export" a rate higher than that permitted by the state's rate ceiling.⁵⁶ Consumers in that state are already paying higher prices to subsidize credit buyers than would be the case in a free market, but that is a general harm that is not related to the out-of-state credit card.

However, if an *in-state* bank is involved, it must abide by the restrictive rate ceiling of the state. Still, the in-state bank has a number of alternatives to adjust to the restrictive rate ceiling. It may charge an annual fee, do away with the "free" or "grace" period on the card, or increase fees for late payments and over-limit charges. Such adjustments are likely to place the in-state bank at a competitive disadvantage in relation to its out-of-state competitors. A more subtle approach is to increase the discount charged retailers for acquiring their credit-card paper. This is exactly the tactic following by the few banks in Arkansas that issue credit cards. Peterson and Falls (1981) found that the average discount rates on bank credit cards ranged from 2.0 percent in Illinois to 3.3 percent in Wisconsin to 3.6 percent in Louisiana, but they averaged 5.5 percent in Arkansas.⁵⁶ A retailer in Arkansas who sold a \$100 obligation to its bank for \$94.50 would obviously have to raise its cash price in order to realize the same profit on the sales as retailers in other states without restrictive rate ceilings. Since all retailers in Arkansas experienced the same problem, all retailers selling on credit could raise their cash prices to compensate for the higher discount rates paid by the banks.

The easy evasion of rate ceilings on sales credit by shifting all or a portion of the finance charge was captured in an often-quoted passage from Bentham: "As far as prodigality, then, is concerned, I must confess, I cannot see the use of stopping the current of expenditure in this way at the fosset, when there are so many unpreventable ways of letting it run out of the bung-hole."

C. Total consumer credit

In view of the restrictions on the availability of credit, one would expect that consumers in Arkansas would have less credit per household than in the other three control states: Louisiana, Illinois and Wisconsin. That turns out not to be the case.

Overall, the data indicate that Arkansas residents held as much credit as consumers located in the other states. In the aggregate, in fact, the total amount of consumer debt per household held by Arkansas respondents insignificantly exceeded the average amount of consumer debt held by other respondents in the sample.⁵⁷

The explanation for this result is quite simple. Unable to obtain cash credit in the amounts desired, Arkansas consumers took a detour and turned to sales credit. Arkansas residents, especially those with low incomes or in high-risk categories, had significantly less cash credit than borrowers in the other states. This deficiency was offset by increased use of sales credit, whose availability was largely unaffected by rate ceilings. The differences in the ratios of sales credit to cash credit between Arkansas and the control states was highly significant (Exhibit 24).⁵⁸

⁵⁶ Peterson and Falls, *op. cit.*, p. 28.

⁵⁷ *Ibid.*, p. 22.

⁵⁸ *Ibid.*, p. 23.

Exhibit 24
Total Household Debt Holdings, Arkansas vs. Control States

	Arkansas	Other	t-Value
Total consumer debt outstanding per household	\$1455.71	\$1,367.68	-0.81
Cash credit (excluding credit cards, and dealer-originated credit)	\$605.59	\$846.52	3.28*
Sales credit (including credit cards) as a percentage of total household debt--			
Average per household	.7286	.5845	-6.22*
* Significantly different at the 10 percent confidence level.			
Source: Peterson and Falls, <i>Impact of Ten Percent Ceiling</i> , 1981, p. 27.			

Finally, in relying on sales credit, Arkansas consumers who had low incomes or were in high-risk categories were much more likely to obtain credit directly from dealers (sellers of autos, household appliances, and so on) than were more affluent consumers, but much less likely to rely on credit card debt, quite possibly because many did not have credit cards. Once again, the least affluent segment of society bore the greatest burden of the regulations that were designed to protect them.

D. Conclusion

Restrictive rate ceilings on cash credit force lenders to deny credit to consumers who pose a high risk or desire only small amounts of credit. These excluded consumers are typically young, have short-time on the job or at their residence, are renters, and are unskilled workers with relatively low incomes. Not only do ceilings ration consumers out of the legal market, but they also drive smaller lenders from the market and thereby diminish competition. Both lenders and consumers find second-best ways around the squeeze imposed by rate ceilings. Where feasible, lenders raise other charges to consumers, and consumers resort to sales or lease credit and various high-cost sources of cash credit, some legal, some not.

Restrictive rate ceilings on sales credit are basically a sham. Denied an adequate return for their credit services, retailers push their shortfall into higher cash prices. Ironically, the higher cash prices adversely affect consumers who have been unable to obtain credit, presumably a group who are less able to afford higher cash prices than the more affluent credit buyers. In-state banks issuing credit cards raise their merchant discounts, an increase that is, again, transmitted to cash buyers through higher prices.

PART IV: CONCLUSIONS

This study has explained the theories underlying the discussion of how credit markets work and the effects upon consumers of government intervention in those markets. Again and again, the data drawn from studies of credit markets with and without restrictive rate ceilings support the theories that have been advanced and accepted by economists over the centuries. The basic conclusions of this study are summarized below.

- The U.S. experience of the past 25 years has validated the faith of the National Commission on Consumer Finance in the power of free and competitive markets to regulate and moderate the price of credit. **The legal ability to raise rates does not correspond to the economic ability to sustain higher rates.** Rates for various types of consumer credit do not necessarily rise to a regulatory ceiling and are less likely to do so, the higher the ceiling. Instead, knowledgeable consumer and unrestricted entry are the economic forces that make credit available at prices commensurate with the costs and risks of providing the credit.
- **In the absence of restrictive rate ceilings, competition expands the range and variety of credit products available to consumers and broadens the risk spectrum of consumers that can benefit from these products.** For example, deregulation of bank credit card rates over the past 15 years spurred entry into the industry and expansion of credit card offers. As a result, both high- and low-risk consumers are now being served within a highly competitive environment where prices adjust to reflect customers' costs and risk.
- **Risk-based pricing, which is difficult or impossible under binding rate ceilings, substantially broadens consumer access to credit.** This is nowhere better demonstrated than in the bank card industry. Deregulation of bank card rates over the past 15 years spurred entry into the industry and expansion of credit card offers. For millions of households who were too risky for bank cards in the 1970s, the rate deregulation of the 1980s gave them access to the most powerful payment mechanism on the planet. Entry spurred dramatic innovations in card features, and ultimately brought us cards that pay us to use them.
- **Risk-based pricing removes the hidden subsidies of high risk borrowers by low risk borrowers, which occurred when all borrowers were charged a rate equal to the average risk of the entire group.** Both groups are served more efficiently when creditors can charge rates commensurate with risk.
- **Restrictive rate ceilings are most harmful to the citizens they were apparently designed to protect.** Regardless of where a ceiling is set, some higher risk consumers needing cash credit are rationed out of the market because the cost of serving them is too high for the creditor to absorb or to pass on as higher rates to lower risk customers. Excluded customers are typically young, have short-time-on-the-job or at their residence, are relatively unskilled workers, have relatively low incomes, or poor credit histories because of past illness or unemployment.
- **Restrictive ceilings on sales credit (credit offered by merchants for purchase of goods or services) are basically a sham.** Denied an adequate return for their credit services, retailers push

their shortfall into higher cash prices. Higher cash prices affect not only customers who borrow, but those who have been unable to get credit, presumably a group who are less able to afford higher cash prices than the more affluent credit buyers.

- **In the end, consumers obtain the credit they need from sources that are inconvenient and at higher prices that do not efficiently reflect cost and risk.**

In short, rate ceilings that are thought to "protect" consumers do not protect consumers and do clear harm to those who are generally at the bottom of the economic ladder. The most reliable way to protect higher risk borrowers is to ensure that they have alternative sources of financing from which to choose. This is accomplished by facilitating the unrestricted entry of new competitors into a market in which the price of credit is free from artificial constraints.

The Cost Structure of the Consumer Finance Industry

Credit Research Center

Working Paper No. 59

Krannert Graduate School of Management – Purdue University

The Cost Structure of the Consumer Finance Industry

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THE COST STRUCTURE OF THE CONSUMER FINANCE INDUSTRY

Erosion of market segmentation in consumer financial services in recent years inevitably raises the issue of future industry structure. If new opportunities to expand produce declining unit costs, a few large firms may come to dominate the market, possibly with adverse effects on market competition. If, in contrast, unit costs do not decline as firms attempt to exploit new opportunities, then large firms do not have a cost advantage. This case will likely produce more firms of various sizes, unless entry is artificially restricted. In such a cost environment, a breakdown of market segmentation should benefit consumers and other users of financial services as they receive the advantages of enhanced competition.

In examining the costs of suppliers of financial services, researchers have focused most of their attention on commercial banks and savings and loan associations (S&Ls).¹ Undoubtedly, the size and importance of these types of financial institutions account for this attention (along with the existence of readily available data), but focusing solely on banks and S&Ls misses much of the picture. Particularly noticeable is the absence of recent studies of consumer finance companies, which hold the second largest share of consumer installment credit (after commercial banks).

The same issues of costs, market structure, and potential competitive impacts that arise concerning banks and S&Ls also surface in the case of the consumer finance industry. Long regarded as specialized and possibly old fashioned, consumer finance companies have recently attracted other institutions' attention because of the finance companies' branch systems, which have always been largely free from regulators' geographical restraints, and because of their profitability during some difficult times for banks and S&Ls. By themselves these features should focus competitive attention on finance companies' cost structure. More generally, however, as financial-product market segmentation continues to break down, all market participants must become more aware of their own and competitors' costs if they are to survive and prosper.

Despite this, researchers have undertaken relatively few cost studies of the consumer finance industry, especially recently.² The major previous effort was by George Benston (1972b) for the National Commission on Consumer Finance. Benston concluded from his statistical work that since scale economies at the firm level were slim to nonexistent, "large companies, as such, are unlikely to dominate the industry because of a 'natural' cost advantage" (1972b, p. 153).³ This view has become the conventional wisdom and has been consistent with casual observation that both large and small consumer finance companies compete in various markets. The question is whether, more than twenty years later, changing conditions (for example, advances in information and computer technology) might produce a different outcome and another conclusion.

Two possibilities suggest themselves. First, technological changes in both risk management and loan administration in the last quarter century might argue for existence of

¹ For an overview of the research and references, see Clark (1988), Humphrey (1990), or Berger et al. (1993).

² The most recent studies are by Benston (1972b, 1977a, 1977b) using 1968-70 data.

³ Durkin and McAlister (1977) found similar results in a regional study using a similar methodology.

larger scale economies than in the past. Large firms, for example, might have better access to sophisticated mathematical credit scoring and other new and expensive techniques for credit evaluation. Likewise, larger firms might be better able to afford computerized marketing, record keeping, and collection procedures and equipment. If such techniques and equipment improved the productivity of large firms relatively more than small ones, economies of scale might be more evident recently than decades ago.⁴ Second, if, in contrast, new technology today is as available to small firms as to large, then economies of scale might not be more evident recently than farther in the past, even if large and small firms might both operate more efficiently today. While the former of these two possibilities might seem more likely, certainly the other possibility remains distinctly possible. Ultimately, the issue of scale economies is an empirical question to be answered by appealing to the data.

The purpose of this paper is to estimate the cost function for the consumer finance company industry using a more appropriate functional form than that employed in older studies and using much newer data. This estimation will permit exploration of the issue of scale economies in this industry as well as discussion of costs by size of loan. Both explorations should be useful for analyzing consumer lending because finance company lending activities produce cost data that are relatively uncontaminated by other products and influences.

The remainder of this paper is divided into three sections. Section II discusses the functional form of the estimation equation and describes the data to be used. Section III presents the empirical results, and section IV offers a brief summary and conclusions.

II. Functional Form and Data

Four important questions arise in any attempt to estimate statistical cost relationships: (1) identification of the production or cost function; (2) the proper specification of the production or cost relations; (3) the definition of output; (4) the availability of data appropriate for estimation.

A. Identification

In most cases, estimates of long-run cost curves and scale economies are possible only by using cross sections of firms in an industry. This involves the implicit assumption that the observations trace out the cost curve for a "typical" firm although no one firm is followed over the whole range of output. Bell and Murphy (1968) and Benston (1972a) have argued that a long-run cost function is identified for a cross section of financial firms because it is reasonable to assume that the level of output is exogenous.⁵ Firms do not have access to secret technology or processes which might provide them an inherent production advantage over their rivals. Thus, demand is not cost determined but rather the opposite. Although technological changes in credit granting and marketing functions might appear to suggest that some firms might have a cost advantage, the technology, including automated credit scoring, is well known to all and widely available through credit bureaus. It is still true that each branch office operates in its own

⁴Rogers (1974), Longbrake (1974), and Lawrence and Shay (1986) investigated the effect of computers on the cost of consumer lending using data from commercial banks participating in the Federal Reserve's Functional Cost Analysis Program. The results of these studies suggest that labor and computers were substitutes. They found little or no overall cost savings and no difference in estimates of scale economies attributable to the use of computers. Because of substantial innovation in computer technology since that time, these results are probably dated.

⁵The level of output is not, however, entirely exogenous. Firms can affect demand by advertising and promotions.

local market subject to the vagaries of demand in its own area.⁶ In effect, companies compete in a succession of local markets with basic technology that is known to all. Under these circumstances, local demands for loans determine the level of output. The cost function can be estimated by a single equation using cross-section data on costs and output. This approach seems appropriate and is adopted here.

B. Specification of Cost Relations

The single-product nature of the consumer finance company industry simplifies specification of the cost relationship.⁷ Consumer finance companies are, of course, financial intermediaries that have a source and use of funds, but unlike the depository and insurance-type intermediaries, whose sources of funds (deposits, policies, pension plans) are products in themselves, the consumer finance companies' funds sources (bonds and commercial paper issued locally and on Wall Street) are largely incidental to the lending function, at least in terms of costs. In a cost sense, they are analogous to the legal or data processing departments. They do not exist apart as separate outputs. Since separate cost functions are not required, arbitrary cost allocations are unnecessary. Similarly, if consumer finance companies produce only one product, there can be no output-cost complementarities or scope economies, and scale and scope economies do not confound.⁸

Total operating costs are a function of input prices and output, with output homogeneity and company structure variables to account for differences in types of loans extended and branch structure among companies. The implicit cost relationship is found in equation 1:

$$1. C = f(Q, P, A, 0)$$

where C is total operating cost, Q is output, P represents input prices, A represents output homogeneity variables (for example, average loan size), and 0 represents company structure variables (for example, number of offices).

Concerning the explicit functional form, the empirical model estimated here employs the translog cost function. Essentially, the translog is a quadratic function of the logarithms of its parameters (namely, output quantity, input prices, and other factors affecting cost), which includes all of the cross products to allow for interactions.⁹

⁶ For discussion of the local nature of the market for consumer financial services see Eliehausen and Wolken (1992).

⁷ See Baumol, Panzar, and Willig (1982) for a general discussion of multiproduct cost functions. Clark (1988) and Humphrey (1990) discuss recent studies of costs at depository institutions.

⁸ Traditional cost studies could possibly confound scale economies and differences in X-efficiency of firms operating at different output levels. This potential problem does not appear to be of practical significance, however. Several researchers have estimated scale economies for financial firms using both traditional cost functions and frontier estimation methods and found little or no differences in results from the two approaches (Berger and Humphrey 1991; Bauer et al. 1993; M. Alister and McManus 1993; Mester 1993). For further discussion, see Berger et al. (1993).

⁹ Sometimes, the effects of control variables are of interest as much as the effect of output on cost. For example, the inclusion of average loan size as an output homogeneity variable permits calculation of a cost elasticity with respect to average size of loan.

$$\begin{aligned}
2. \ln C = & a_0 + a_Q \ln Q + \frac{1}{2} b_{QQ} (\ln Q)^2 + a_L \ln P_L + a_K \ln P_K + \frac{1}{2} b_{LL} (\ln P_L)^2 \\
& + \frac{1}{2} b_{KK} (\ln P_K)^2 + b_{LK} \ln P_L \ln P_K + b_{QL} \ln Q \ln P_L + b_{QK} \ln Q \ln P_K + d_A \ln A \\
& + \frac{1}{2} d_{AA} (\ln A)^2 + d_{AQ} \ln A \ln Q + d_{AL} \ln A \ln P_L + d_{AK} \ln A \ln P_K + d_0 \ln 0 \\
& + \frac{1}{2} d_{00} (\ln 0)^2 + d_{AO} \ln A \ln 0 + d_{0Q} \ln 0 \ln Q + d_{0L} \ln 0 \ln P_L + d_{0K} \ln 0 \ln P_K
\end{aligned}$$

The translog cost function to be estimated is shown in equation 2. where C = total operating cost; Q = output quantity; PL = price of labor; PK = price of capital; A = average size of loans made; and 0 = total number of branch offices.

In order to correspond to a well-behaved production function, a cost function must be positively linearly homogeneous in input prices. This theoretical requirement imposes the following restrictions on the parameters of the translog cost function:

$$3. a_L + a_K + b_{QL} + b_{QK} = 0; b_{LL} + b_{LK} = b_{LK} + b_{KK} = 0; d_{AL} + d_{AK} = 0; d_{0L} + d_{0K} = 0$$

The translog is a valid local second-order approximation to an arbitrary cost function.¹⁰ Under reasonable assumptions (nonnegative, real valued, nondecreasing function of output, linearly homogeneous in input prices), the translog is dual to a general production or transformation function, although it is not directly derivable from them (Diewert 1971; Caves, Christensen, and Tretheway 1980).

Because of its greater generality, the translog functional form offers a number of advantages. First, it permits estimation of U-shaped average cost curves. Second, it permits exploration of how factor prices may affect scale economy results (nonhomotheticity). Third, it permits estimation of scale, branch office, and account size economies and allows them to vary by size of institution.¹¹

C. Definition of Output

To estimate a statistical cost function, it is necessary to relate cost measurements directly to measures of the outputs that produce the costs. The output of the consumer finance industry is loans, but a number of potential output measures exist: number of loans made, dollar amount made, number serviced, amount serviced, and total assets devoted to lending. In considering

¹⁰ The translog cost function is flexible at the point of approximation, but it imposes generally a specific structure, namely, a symmetric U-shaped average cost curve. If this assumption does not hold generally, then the cost function would be misspecified, and estimates of scale economies derived from it would be biased. In studies of commercial bank costs, bias in translog estimates of scale economies appears to result largely from differences in the output mixes of small and large banks (McAlister and McManus 1993). This consideration probably would not bias translog estimates of scale economies for consumer finance companies because consumer finance companies produce essentially a single product.

¹¹ Both homogeneity and homotheticity can be imposed on the translog form by constraining the parameters in estimation. Thus, homogeneous, homothetic, and Cobb-Douglas forms can be tested as subsets of the analysis. Tests by the authors (available on request) reject homotheticity and homogeneity and, therefore, the Cobb-Douglas formulation. An important implication is that the percentage change in cost resulting from a given percentage change in output is not the same at different levels of output. In other words, economies of scale are not constant over all output levels.

these possibilities, it seems that costs are more likely to be related to the number of loans rather than amounts of loans or total assets. Many cost-causing activities such as recording and booking loans and payments must be undertaken for each loan and probably vary very little, if at all, with size of loan. This suggests that numbers of loans made or serviced are the candidates for the output variable. Of these, the number serviced seems the more reasonable choice. Most consumer loans require periodic payments (typically monthly), and so both the number of employees and the size of the systems, paperwork, and compliance efforts involve more than just making loans. In fact, it seems that the size or scale of a lending operation is more dependent on the number of loans serviced (which require regular and recurring activities) than on loans made (which are more irregular and discontinuous). Consequently, the output variable employed in this study is number of loans outstanding (that is, serviced) rather than number made. Average size of loans outstanding is included in the regression as an output homogeneity variable. Care and credit checking and some other cost-causing activities of making and servicing a loan are generally greater for larger loans than for smaller loans. Larger loans are also more likely than smaller loans to be secured, a process that creates added costs.

D. Data

Cost data for estimation are from the American Financial Services Association (AFSA), the renamed trade group that supplied finance-company data to Benstor in 1972. The AFSA surveyed its finance company members annually between 1960 and 1989 to collect information on the consumer finance industry.¹² Data for 1987-9 were available for this study. Survey schedules include detailed balance sheets, income and expense statements, loan activity, delinquency, and loss reports. Companies providing usable reports numbered 84 to 101 over the three years. These companies ranged from very small, including about one-third single-office companies, to the largest finance companies in the industry. In all, the companies had total assets of \$245-350 billion. Their gross consumer receivables represented 73 to 88 percent of the Federal Reserve's estimate of total consumer credit at consumer finance companies, depending on the year.

For this study, we used data for 51 companies that had greater than 50 percent of their receivables in consumer credit and reported costs in each of the three years. These restrictions ensure that the results reflect the costs of consumer lending rather than business lending or leasing and that any differences among the years are not due to differences in the composition of the samples.¹³

Table I lists the variables used in the statistical estimation and the sample means and standard deviations for these variables. The dependent variable is total annual operating expense excluding losses, advertising (which concerns demand, not production costs), and cost of funds. Independent variables are output (average number of loans serviced during the year), input prices (labor and capital prices), average size of loans serviced, and a structural variable (average number of branch offices). The price of labor for a company is the average annual wage rate, which is calculated as total annual salary and wage expenses including social security and fringe benefits divided by the average number of employees. The price of capital is

¹² These surveys were discontinued after 1989.

¹³ On average, consumer receivables were about 95 percent of the total number of accounts and 90 percent of the total dollar amount of receivables at these companies during 1987-9. The subsample of companies preserves the range of company sizes in the full sample.

the replacement cost per square foot of office buildings. It is computed for each company by weighting regional estimates of the cost of office space compiled by the F.W. Dodge Company (1987-89) by the proportion of the company's offices located in each region. The AFSA's office directory provided the addresses necessary for calculating the weights.

III. Empirical Results

This paper estimates the cost function (equation 2) restricted to be positively linearly homogeneous in input prices (equations 3) jointly with input-demand equations (equations 4 and 5 below). The input demand equations are obtained by differentiating the translog cost function with respect to the input prices, P_L and P_K .¹⁴

$$4. \quad \partial \ln C / \partial \ln P_L = S_L = a_{LL} + b_{LL} \ln P_L + b_{LK} \ln P_K + b_{QL} \ln Q + d_{AL} \ln A + d_{OL} \ln O$$

and

$$5. \quad \partial \ln C / \partial \ln P_K = S_K = a_{KK} + b_{KK} \ln P_K + b_{LK} \ln P_L + b_{QK} \ln Q + d_{AK} \ln A + d_{OK} \ln O$$

where S_L and S_K are the cost shares of labor and capital. This procedure is recommended by Christensen and Green (1976) because the input-demand equations add degrees of freedom without adding any unrestricted regression parameters, resulting in more efficient parameter estimates than would be obtained by estimation the cost function alone.¹⁵

Random disturbance terms are added to the cost function and input-demand functions. We assume that the disturbances are correlated across equations but not across firms (see Zellner 1962). Because cost shares must sum to unity, one of the input-demand equations is redundant. The capital input-demand equation is therefore dropped, and the cost function and labor input-demand function are estimated jointly using the iterated version of Zellner's seemingly unrelated regression procedure. This procedure produces maximum likelihood estimates of the parameters, which are invariant to which one of the input-demand equations is dropped (Kmenta and Gilbert 1968).

Table II presents results of estimation. According to the likelihood-ratio test, the estimated cost and input-share equations are significant in each of the three years 1987-89. Adjusted R-squares of the cost functions are between 0.980 and 0.988.

A. Estimates of Economies of Scale

Economies of scale are measured as the percentage change in cost resulting from a small percentage change in output. There are two types of estimates of scale economies, which involve different assumptions about the relationship between costs and outputs, that have been derived for financial institutions (see Benston, Hanweck, and Humphrey 1982).

¹⁴ This result is known as Shephard's lemma (Shephard 1953).

¹⁵ In other recent studies of financial firms' costs, Benston, Hanweck, and Humphrey (1982) and Gilligan, Smirlock, and Marshall (1983) estimated only cost functions. Mester (1987) and Kim and Zion (1989), on the other hand, estimated cost functions jointly with input-demand equations.

A simple scale economies measure is the cost elasticity when the number of production facilities (offices) does not change as output varies. An augmented scale economies measure allows the number of offices to vary along with output.

1. Simple Scale Economies. The simple scale economies measure (SCE) is derived by differentiating the translog cost function with respect to output.

$$6. \text{ SCE} = \frac{\partial \ln C}{\partial \ln Q} = a_Q + b_{QQ} \ln Q + b_{QL} \ln P_L + b_{QK} \ln P_K + d_{AQ} \ln A + d_{OQ} \ln O$$

SCE values less than one indicate the presence of scale economies; values equal to one indicate constant costs; and values more than one indicate diseconomies of scale.

Equation 6 indicates that scale economies depend on the level of factor prices, average account size, and number of offices as well as output. For estimates of the simple scale economies measure, we hold all variables constant except output. In the first three columns of table III, SCE is computed at various levels of output for 1987-9. Means of the third output quintile are assumed for P_L , P_K , A , and O . These SCE estimates can be viewed as scale economies facing a "typical" medium-sized firm.¹⁶

Estimates of the simple scale economies measure suggest that there are economies of scale in operating costs of consumer finance companies and that these scale economies diminish as output increases. For a medium-sized firm operating at low levels of output, SCE estimates indicate that a 10 percent increase in output raises costs about 4-6 percent in the 0.6-3.4 thousand accounts output range. Scale economies gradually fall from the second to the fourth output quintiles; a 10 percent increase in output raises costs about 5-7 percent in the second quintile and about 7-9 percent in the fourth quintile. In the fifth quintile, economies of scale appear to be exhausted. Estimates of the scale economies measure generally are not significantly less than one for the fifth quintile.¹⁷

2. Augmented Scale Economies. To allow adjustment of the number of offices for the level of output, Benston, Hanweck, and Humphrey (1982) developed an augmented scale economies measure. They defined the augmented scale economies measure as

$$7. \text{ SCE}^* = \text{SCE} + (\partial \ln C / \partial \ln O) / (\partial \ln O / \partial \ln Q),$$

where $\partial \ln C / \partial \ln O$ is a measure of office economies and $\partial \ln O / \partial \ln Q$ indicates the change in offices associated with a change in output. Again, values less than one indicate the presence of scale economies; values equal to one indicate constant costs; and values more than one indicate diseconomies of scale.

For the translog function, the measure of office economies is

¹⁶ On average, firms in the third output quintile had 47 offices.

¹⁷ As mentioned, these estimates of scale economies apply to the medium-sized firms in terms of number of offices. Different values of SCE would be obtained if the number of offices were different, although the finding of significant scale economies would generally hold. The assumption that firms keep the number of offices constant may be appropriate in the short run, but it probably is unrealistic over longer periods of time. Firms might avoid diseconomies of scale by opening additional offices, or to the extent allowed by the size of their geographic markets, they may realize scale economies by consolidating accounts in a smaller number of offices.

$\partial \ln C / \partial \ln O = d_C + d_{OO} \ln O + d_{OQ} \ln Q + d_{OL} \ln P_L + d_{OK} \ln P_K + d_{AO} \ln A$. We estimate the change in offices associated with a change in output, $\partial \ln O / \partial \ln Q$, by the regression $\ln O = e_0 + e_1 \ln Q + e_2 (\ln Q)^2$.

To estimate SCE*, we use the same output levels that were used for estimates of the simple scale economies measure and the appropriate mean number of offices for each quintile. Factor prices and average account size are held constant; we use means of the third output quintile for P_L , P_K , and A to maintain comparability with estimates of the simple scale economies measure.

The augmented scale economies measure provides a better indication of scale economies facing the firm. None of the estimates of the augmented scale economies measure shown in the last three columns of table III is significantly less than one. This result suggests that firms can adjust the number of offices to exploit all scale economies. According to these estimates, even relatively small firms are able to operate at approximately constant costs. None of the estimates of the augmented scale economies measure is significantly greater than one either, which suggests that firms can also adjust the number of offices to avoid diseconomies of scale.

3. Discussion. As mentioned, the simple scale economies measure SCE indicates the effect on cost of changes in the level of output for a fixed number of offices and thus can be viewed as a measure of economies of scale at the office level. The augmented scale economies measure SCE* allows the number of offices to vary as well as the level of output and can be viewed as a measure of scale at the firm level. The finding of economies of scale at the office level (SCE) but not at the firm level (SCE*) is consistent with Benston's earlier findings. Thus, our analysis indicates Benston's findings are robust, despite the simplifying assumptions implicit in his methodology. Although we find economies of scale at the office level, our estimates indicate that these economies decrease as output increases.¹⁸

A. Cost Elasticity of Average Loan Size

We also estimated cost elasticities of average loan size, which show relationship between operating costs and the average size of loans in creditors' portfolios. An elasticity less than one suggests that firms producing smaller loans have higher costs per dollar of credit than firms producing larger loans. Such might be the case if some expenses of consumer credit—for example, recording and booking loans and payments—are relatively constant and not related to the size of the loan.

For the translog cost function, the cost elasticity of average loan size (SCA) is

$$SCA = \frac{\partial \ln C}{\partial \ln A} = d_A + d_{AA} \ln A + d_{AQ} \ln Q + d_{AL} \ln P_L + d_{AK} \ln P_K + d_{AO} \ln O$$

Like SCE and SCE*, SCA depends on the values assumed for number of loans outstanding, factor prices, and number of offices as well as average loan size. We assume average values of

¹⁸ An appendix to an earlier version of this paper updates Benston's estimations using data from the more recent period. The estimated scale economies at the office and firm levels for 1987-89 using Benston's methods are similar to Benston's 1968-70 estimates. A copy of this appendix is available from the authors on request.

Q , p_L , P_K , and 0 . Values chosen for A lie between the 10th and 90th percentile of the sample distribution of average loan size.

Estimates of SCA shown in table IV are significantly less than one for most average loan sizes, suggesting that smaller loans are indeed relatively more expensive to produce than larger loans. At an average loan size of \$2,210 (the median average loan size in the sample), for example, a 10 percent increase in average loan size would increase costs about 2.5-3.0 percent, or about 1 percent for a \$1 increase in average loan size. At an average loan size of \$8,620 (the 90th percentile), estimated values of SCA indicate that a 10 percent increase in average loan size would increase costs about 4.5-5.0 percent, which is about 0.5 percent for a \$1 increase in average loan size.

Our finding that operating costs at finance companies rise less than proportionately with increases in average loan size is similar to results of earlier studies.¹⁹ Unlike earlier studies (which constrained cost elasticities of average loan size to a constant value because they used Cobb-Douglas cost functions), our estimates of the cost elasticity of average loan size rise as average loan size increases. This result seems reasonable. Firms evaluate credit applications more carefully, take collateral, monitor more frequently, and make greater efforts to collect overdue accounts on larger loans than on smaller loans.

IV. Conclusions

Scale economies are an important factor determining the structure of an industry. If scale economies exist, an industry may come to be dominated by a few large firms. Such an outcome would reduce the cost of providing a product, but it could also adversely affect competition. Research conducted in the early 1970s concluded that significant scale economies existed in the consumer finance industry at the office but not at the firm level. The results suggested that although larger finance companies were not more efficient than smaller finance companies, firms could nevertheless have reduced costs by consolidating business in fewer offices. This anomaly results from the use of a restrictive functional form, the Cobb-Douglas cost function, which limits estimates of scale economies to a constant value. Consequently, estimates of scale economies may not reflect the cost relationships at all levels of output.

This study uses the more general transcendental logarithmic functional form and newer data to investigate scale economies in the consumer finance industry. The results reject the restrictive assumptions of the Cobb-Douglas cost function. Significant scale economies are found at the office level, and these scale economies decline as output increases. Thus, increasing office volume beyond a certain number of accounts (for the "typical" medium-sized firm of Table III about 1 million accounts in 47 offices) yields no additional savings in operating costs. The finding of a limit to the size of offices is an important difference from previous estimates of scale economies that relied on the Cobb-Douglas formulation.

At the firm level, neither significant economies nor diseconomies of scale are detected throughout most of the range of output levels in the industry. This finding-----together with the finding of significant, decreasing scale economies at the office level-----is consistent with the

¹⁹ For 1968-70, Benston (1972b) estimated cost elasticities of average loan size between 0.391 and 0.592 depending on year; and in a regional study, Durkin and McAlister (1977) obtained average loan size cost elasticities between 0.293 and 0.504 for 1968-73.

view that finance companies are generally able to adjust their offices to exploit scale economies or avoid scale diseconomies. Size of firm does not confer a cost advantage.

Failure to find scale economies at the firm level (and the finding of decreasing scale economies at the office level) suggests that the benefits technological change in the lending business over the past two decades have not exclusively accrued to the benefit of larger firms. There have been, of course, important developments in office automation equipment, but these do not appear to have generated significant scale economies in consumer lending at finance companies. Likely, the availability of smaller and smaller computers with ever greater computing power at lower and lower cost has been important in this respect. Today office automation equipment is within the budget of even the smallest companies. Similarly, sophisticated mathematical credit evaluation systems have become with the reach of even the smallest firms in recent years with the development of generic scoring-model results that are available instantaneously from credit bureaus with routine purchase of individual credit reports. It is not obvious that large firms have any decided advantage in this area either.

Our results also confirm earlier findings that operating costs rise less than proportionately with average loan size (Table IV). This result suggests that smaller loans are relatively more expensive to produce than larger loans. However, we also find that the relative savings in operating costs decline as loan size increases, probably because firms incur greater costs for credit evaluation, obtaining collateral, monitoring, and collection for larger loans than for smaller loans.

In sum, our findings for consumer finance companies are consistent with most of the recent evidence on scale economies at other financial institutions, which find little or no evidence of economies or diseconomies of scale. We find that smaller finance companies do not operate at a cost disadvantage to larger finance companies. Despite advances in information and computer technology, many of the activities associated with loan acquisition and maintenance may still be labor intensive and not provide much scope for scale economies. It is also likely that personal computers are accessible to even the smallest finance companies, so that any cost savings from this source would be available to all. Thus, operating costs would not lead to consolidation in the consumer finance industry.

The implications of these findings are that public policies that promote competition better serve customers than those that might seek cost savings by restricting entry or encouraging consolidation of firms.

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Table I
Descriptive Statistics

Mean (standard deviation)

Variable	1987	1988	1989
Operating cost, excluding losses, advertising, and cost of funds; in thousands of dollars (C)	145,244.8 (388,211.7)	158,032.7 (381,124.0)	173,154.8 (397,775.9)
Output, average of number of accounts and notes outstanding at the beginning and end of the year, in thousands (Q)	569.0 (1,413.2)	600.9 (1,447.1)	629.8 (1,442.7)
Price of labor, annual wage and salary expense divided by average of number of employees at the beginning and end of the year, in thousands of dollars (P _L)	25.2 (6.3)	25.8 (6.7)	27.0 (6.4)
Price of capital, replacement cost per square foot for office buildings, in dollars (P _K)	82.1 (8.6)	88.2 (11.8)	93.6 (10.9)
Average size of loans serviced, average of the dollar amount to the number of accounts and notes outstanding at the beginning and the end of the year, in thousands of dollars (A)	3.2 (2.8)	3.5 (3.2)	3.7 (3.6)
Number of branch offices, average of the number of offices at the beginning and end of the year (0)	189.9 (280.6)	204.9 (317.7)	204.0 (317.1)

Table II

Cost Function Parameter Estimates
(Standard errors in parentheses)

Variable and Parameter		1987	1988	1989
Constant	(a ₀)	1.548 (.110)**	1.580 (.095)**	1.606 (.104)**
lnQ	(a _q)	.730 (.087)**	.638 (.077)**	.589 (.084)**
(lnQ) ²	(b _{qq})	.071 (.066)	.060 (.044)	.045 (.046)
lnP _L	(a _L)	.769 (.068)**	.863 (.050)**	.876 (.070)
lnP _L lnP _K	(b _{LK})	-.149 (.046)**	-.202 (.032)**	-.191 (.047)**
lnP _Q lnP _L	(b _{QL})	-.077 (.016)**	-.067 (.012)**	-.054 (.012)**
lnA	(d _A)	.288 (.127)*	.202 (.122)	.180 (.122)
(lnA) ²	(d _{AA})	.138 (.174)	.161 (.149)	.110 (.161)
lnA lnQ	(d _{AQ})	-.041 (.084)	.002 (.007)	.086 (.081)
lnA lnP _L	(d _{QL})	-.044 (.027)	-.067 (.021)**	-.078 (.022)**
lnA lnO	(d _{AO})	-.007 (.099)	-.037 (.082)	-.102 (.097)
lnO	(d _O)	.274 (.121)*	.387 (.108)**	.409 (.119)**
(lnO) ²	(d _{OO})	.075 (.098)	.071 (.069)	.115 (.077)

InO lnQ	(d _{OQ})	-.072 (.070)	-.065 (.044)	-.077 (.046)
InO lnP _L	(d _{OL})	.071 (.018)**	.058 (.014)**	.045 (.014)**
Adjusted R-square		.980	.985	.988
Likelihood ration		87.945	87.807	87.347

*/** Coefficient is significantly different from zero at the 95/99 percent confidence level.

Table III

Estimated Scale Economy Coefficients By Output Level and Output Quintile

Output level, in thousands	Simple scale economy Coefficients (SCE) ¹			Augmented scale economy Coefficients (SCE*) ²		
	1987	1988	1989	1987	1988	1989
First quintile						
.6	.462	.438*	.438*	1.001	1.007	1.017
.7	.473	.447*	.455*	.998	1.005	1.011
3.4	.585*	.543**	.517**	.972	.987	.962
Second quintile						
4.8	.610*	.564**	.532**	.981	.988	.978
6.2	.628*	.579**	.543**	.978	.985	.971
14.1	.687*	.628***	.581**	.970	.979	.946
Third quintile						
23.5	.724*	.660**	.604**	.991	.980	.993
38.2	.758**	.689**	.626**	.985	.976	.978
88.0	.818**	.739**	.663**	.979	.970	.954
Fourth quintile						
191.0	.873*	.786**	.698**	.987	.966	.978
236.1	.888	.799**	.708**	.985	.964	.971
780.0	.974	.871	.762*	.981	.960	.938
Fifth quintile						
1,236.8	1.007	.899	.783*	.982	.956	.941
1,839.9	1.035	.923	.801	.982	.955	.931
5,645.0	1.115	.991	.851	.985	.955	.903

1. Evaluated at mean values of P_L, P_K, A, and 0 in the third output quintile.

2. Evaluated at mean values of P_L, P_K, and A for the third output quintile and quintile means of 0.

*/** Coefficient is significantly less than one at the 95/99 percent confidence level.

Table IV

Cost Elasticity of Average Loan Size
By Average Loan Size

Average loan size, in thousands of dollars ¹	Cost elasticity of average Loan size (SCA) ²		
	1987	1988	1989
.98	.153**	.146**	.211**
1.38	.200**	.201**	.249**
2.21	.265*	.277**	.300**
4.52	.363	.392**	.379**
8.62	.452	.496*	.449**

1. Values of A are selected points of the sample distribution of average loan size between the 0th and 90th percentiles.

2. Evaluated at mean values of P_L , P_K , A, and 0 for the third output quintile.

*/**Coefficient is significantly less than one at the 95/99 percent confidence level.

These are a list of the changes made to the 'Y' version of HB 227

- Page 2, lines 5-6 – delete.
- Page 3, line 18 – change \$5,000 to \$10,000.
- Page 6, lines 11-14 – revise language to treat Internet location as a separate licensed location. Also we need to define the term location – to clarify if we are allowing/requiring out of state locations.
- Page 7, line 31 – after “engaged in” insert **lending or reporting**.
- Page 8, lines 2-5 – insert language to include endorsees.
- Page 9, lines 1-4 – after “under this chapter” insert **in accordance with AS 06.01.015(a)**.
- Page 9, line 6 – after “examinations” insert **or investigations**.
- Page 9, lines 15-16 – after \$75 insert **per examiner hour**.
- Page 9, lines 19-21 – after “use in the” insert **licensed premises those books, accounts, and records that will enable the department to determine whether the licensee is complying with this chapter and with the regulations lawfully adopted by the department under this chapter.**
- Page 10, lines 13-21 – there is agreement that current statute language is better than these changes, however there is concerns that some modification may be necessary to make the whole act internally consistent. Please advise.
- Page 11, line 13 – delete 12 C.F.R 226.15, insert correct reference to Truth In Lending.
- Page 11, new section: AS 06.20.240
- I am hoping you can propose language that would amend this section in such a way that it is consistent with the rest of the new bill. Can you provide an example of what activity this section would regulate in a straight rate environment? In light of the amendment to 06.20.230, this section may need to be repealed. Please advise.
- Page 12, line 17 – delete \$25, insert language to reference maximum as stated in AS 09.68.115.
- Pages 13-14 – insert current statute language from 06.20.270**(5) display prominently in each licensed place of business a full and accurate schedule, approved by the department, of the charges to be made and the method of computing them.**
- Page 15-16 – The parties have agreed to make no change to AS 06.20.320, only those changes to make the current .320 fit with all our new changes.
- Page 18, line 18 – delete 06.20.020(b).
- Page 18, line 18 insert 06.20.220.
- Page 18, lines 28-30 – change dollar amount to “two times the maximum amount under AS 06.20.330.”

FISCAL NOTE

STATE OF ALASKA
2006 LEGISLATIVE SESSION

Fiscal Note Number: _____
 Bill Version: CSHB 227 (L&C)
 () Publish Date: _____

Revision Date/Time (Note if correction): _____ Dept. Affected: Commerce
 Title Alaska Small Loans Act RDU Banking & Securities (536)
 Component Banking & Securities
 Sponsor Labor and Commerce
 Requester Labor and Commerce Component No. 2808

Expenditures/Revenues (Thousands of Dollars)

Note: Amounts do not include inflation unless otherwise noted below.

OPERATING EXPENDITURES	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
Personal Services						
Travel						
Contractual						
Supplies						
Equipment						
Land & Structures						
Grants & Claims						
Miscellaneous						
TOTAL OPERATING	0.0	0.0	0.0	0.0	0.0	0.0
CAPITAL EXPENDITURES						
CHANGE IN REVENUES (1156)	3.0	3.0	3.0	3.0	3.0	3.0

FUND SOURCE (Thousands of Dollars)

1002 Federal Receipts						
1003 GF Match						
1004 GF						
1005 GF/Program Receipts						
1037 GF/Mental Health						
Other						
TOTAL	0.0	0.0	0.0	0.0	0.0	0.0

Estimate of any current year (FY2006) cost: 0.0
 Mark this box (X) if funding for this bill is included in the Governor's FY 2007 budget proposal:

POSITIONS

Full-time						
Part-time						
Temporary						

ANALYSIS: (Attach a separate page if necessary)

This legislation implements several provisions to the Alaska Small Loans Act (AS 06.20). It raises the maximum loan amount from \$25,000 to \$50,000 and removes the 36 percent maximum rate for loans less than \$850.00 and the blended rates for loans over \$850.00. The bill has the most impact on loans over \$10,000 by imposing an interest cap on loans to 24 percent. Currently there is no maximum limit on interest rates on loans over \$10,000. In addition, the cap of 24 percent extends to loans up to \$50,000.

Prepared by: Mark Davis, Director Phone 907.465.2521
 Division: Banking and Securities Date/Time 3/16/06 3:19 PM
 Approved by: William C. Noll, Commissioner Date 3/16/2006
 Agency: Commerce, Community, and Economic Development

Newest Changes to HB 227 24-LS0599\Y

Page 2, lines 5-6 – delete. Rationale: No reason to exempt insurance companies; please remove. Per Jeffrey Trout (phone call of 3/13/06), deputy director Insurance, he needs to check w/his staff however stated initially he sees no reason to support this exemption.

Page 3, line 18 – change \$5,000 to \$8,000. Rationale: keep increase consistent between single licenses and multiple licenses.

Page 6, lines 11-14 – revise language to treat Internet location as a separate licensed location. Rationale: If company A. does business at branch 1, 2, and 3 and company B does business at branch 1 and online, the internet “location” should be licensed as a separate branch. Also we need to define the term location – to clarify if we are allowing/requiring out of state locations.

Page 7, line 31 – after “engaged in” insert lending or reporting.

Page 8, lines 2-5 – insert language to include endersees. Rationale: we allow for multiple licenses therefore we should allow for transfer between those branches by a single licensee

Page 9, lines 1-4 – after “under this chapter” insert in accordance with AS 06.01.015(a).

Page 9, line 6 – after “examinations” insert or investigations.

Page 9, lines 15-16 – after \$75 insert per examiner hour.

Page 9, lines 19-21 – after “use in the” insert licensed premises those books, accounts, and records that will enable the department to determine whether the licensee is complying with this chapter and with the regulations lawfully adopted by the department under this chapter.

Page 10, lines 13-21 – there is agreement that current statue language is better than these changes, however there is concerns that some modification may be necessary to make the whole act internally consistent. Please advise.

Page 11, line 13 – delete 12 C.F.R 226.15, insert 12 C.F.R. 228.18

Page 11. new section: AS 06.20.240

I am hoping you can propose language that would amend this section in such a way that it is consistent with the rest of the new bill. The purpose of provisions such as this one is to address potential abuse in a split rate environment. Because we are amending section 06.20.230 and going from a split rate to a straight rate, this provision no longer serves any purpose. With a straight rate, there is no longer potential to “split loans” in such a way as to violate the (split-rate) interest provisions. Can you provide an example of what activity this section would regulate in a straight rate environment? In light of the amendment to 06.20.230, this section may need to be repealed. Please advise.

Page 12, line 17 – delete \$25, insert language to reference maximum as stated in AS 09.68.115.

Pages 13-14 – insert current statute language from 06.20.270(5) **display prominently in each licensed place of business a full and accurate schedule, approved by the department, of the charges to be made and the method of computing them.**

Page 15-16 – The parties have agreed to make no change to AS 06.20.320, only those changes to make the current .320 fit with all our new changes.

Page 18, line 18 – delete 06.20.020(b).

Page 18, line 18 insert 06.20.220. Rationale: Modernize payment process.

Additional amendment: how can we exempt real estate loans from \$25-50k?

FISCAL NOTE

STATE OF ALASKA
2006 LEGISLATIVE SESSION

Fiscal Note Number: _____
 Bill Version: CSHB 227 (L&C)
 () Publish Date: _____

Revision Date/Time (Note if correction): _____ Dept. Affected: Commerce
 Title Alaska Small Loans Act RDU Banking & Securities (536)
 Component Banking & Securities
 Sponsor Labor and Commerce
 Requester Labor and Commerce Component No. 2808

Expenditures/Revenues (Thousands of Dollars)

Note: Amounts do not include inflation unless otherwise noted below.

OPERATING EXPENDITURES	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
Personal Services						
Travel						
Contractual						
Supplies						
Equipment						
Land & Structures						
Grants & Claims						
Miscellaneous						
TOTAL OPERATING	0.0	0.0	0.0	0.0	0.0	0.0

CAPITAL EXPENDITURES						
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CHANGE IN REVENUES (1156)	3.0	3.0	3.0	3.0	3.0	3.0
----------------------------------	------------	------------	------------	------------	------------	------------

FUND SOURCE (Thousands of Dollars)

1002 Federal Receipts						
1003 GF Match						
1004 GF						
1005 GF/Program Receipts						
1037 GF/Mental Health						
Other						
TOTAL	0.0	0.0	0.0	0.0	0.0	0.0

Estimate of any current year (FY2006) cost: 0.0
 Mark this box (X) if funding for this bill is included in the Governor's FY 2007 budget proposal:

POSITIONS

Full-time						
Part-time						
Temporary						

ANALYSIS: (Attach a separate page if necessary)

This legislation implements several provisions to the Alaska Small Loans Act (AS 06.20). It raises the maximum loan amount from \$25,000 to \$50,000 and removes the 36 percent maximum rate for loans less than \$850.00 and the blended rates for loans over \$850.00. The bill has the most impact on loans over \$10,000 by imposing an interest cap on loans to 24 percent. Currently there is no maximum limit on interest rates on loans over \$10,000. In addition, the cap of 24 percent extends to loans up to \$50,000.

Prepared by: Mark Davis, Director
 Division: Banking and Securities
 Approved by: William C. Noll, Commissioner
 Agency: Commerce, Community, and Economic Development

Phone 907.465.2521
 Date/Time 3/16/06 3:19 PM
 Date 3/16/2006

Alaska State Legislature

House of Representatives



Official Business

State Capitol
Juneau, AK 99801-1182

SPONSOR STATEMENT FOR HB 227 BY: Representative Tom Anderson

TITLE: "An Act relating to the Alaska Small Loans Act; and providing for an effective date."

The last significant revision of the Alaska Small Loans Act (ASLA) occurred between 1995 and 1996. The bill (then numbered HB 319) was signed into law in July 1996 and brought this section of statute up-to-date with the changing market demands. There have been several changes to the market in the last decade, and more importantly, there has been many more changes in technology. As computer systems become more and more adept at taking, storing, sorting, and retrieving information, our laws must reflect the most efficient use of those innovations.

House Bill 227, the latest revision of AS 06.020, takes into account not only the market-driven or technological changes, but also the changes in the value of money. Put simply, goods cost more today than they did twenty, ten, or even five years ago. For example, it is not unheard of to pay between \$7,500 and \$10,000 for an ATV or snowmachine. Also, manufacturer's list prices for new automobiles can start as high as \$40 - \$50,000. Clearly the definition of what constitutes a small loan needs some adjustment.

HB 227 improves the business environment by encouraging industry competition, which ultimately should decrease loan prices as well as providing consumers additional products and services to choose from. HB 227 will also update the Small Loans Act to reflect current technology. As written today, the law does not recognize automated or centralized process utilized by most companies today.

We worked with both members of financial community and with the Division of Banking and Securities to find language balancing the parties' wish lists and consumer protection. HB 227 updates the ASLA to make the law reflective of current industry practices and raises the limit of a small loan from \$25,000 to \$50,000 broadening the Department's regulatory oversight. Additionally, it doubles the liquid assets and bond requirements from \$25,000 to \$50,000 for businesses writing small loans.

I would ask for your support on HB 227.

HB

240

FISCAL NOTE

STATE OF ALASKA
2006 LEGISLATIVE SESSION

Fiscal Note Number: _____
 Bill Version: HB240-DPS-ABC-3-20-06
 () Publish Date: _____

Revision Date/Time (Note if correction): _____ Dept. Affected: Public Safety
 Title "An Act relating to brewery and brew pub licensing." RDU Alcoholic Beverage Control Board
 Component ABC Board
 Sponsor House Judiciary Committee
 Requester House Labor and Commerce Committee Component No 2690

Expenditures/Revenues (Thousands of Dollars)

Note: Amounts do not include inflation unless otherwise noted below.

OPERATING EXPENDITURES	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
Personal Services						
Travel						
Contractual						
Supplies						
Equipment						
Land & Structures						
Grants & Claims						
Miscellaneous						
TOTAL OPERATING	0.0	0.0	0.0	0.0	0.0	0.0

CAPITAL EXPENDITURES						
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CHANGE IN REVENUES ()						
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FUND SOURCE (Thousands of Dollars)

1002 Federal Receipts						
1003 GF Match						
1004 GF						
1005 GF/Program Receipts						
1037 GF/Mental Health						
Other (Specify Type--Do not abbreviate)						
TOTAL	0.0	0.0	0.0	0.0	0.0	0.0

Estimate of any current year (FY2006) cost: 0.0
 Mark this box (X) if funding for this bill is included in the Governor's FY 2007 budget proposal:

POSITIONS

Full-time						
Part-time						
Temporary						

ANALYSIS: (Attach a separate page if necessary)

This legislation will not have a fiscal impact on expenditures for the Department of Public Safety. A very small increase in revenues could be realized if any of the existing brewpubs were to upgrade to a brewery and pay the corresponding increased license fees.

Prepared by: Director Douglas B. Griffin
 Division: Alcoholic Beverage Control Board
 Approved by: Commissioner William Tandeske
 Agency: Department of Public Safety

Phone 907-269-0351
 Date/Time 3/21/06 9:02 AM
 Date 3/21/2006

By Kott

#1

Passed ✓

24-LS0734P.2
Lucchaupt
4/11/06

AMENDMENT

OFFERED IN THE HOUSE

TO: CSHB 240(), Draft Version "P"

- 1 Page 2, line 20:
- 2 Delete "46,500"
- 3 Insert "37,200"
- 4
- 5 Page 3, line 14:
- 6 Delete "46,500"
- 7 Insert "37,200"

By Kott #2

PASSED OK

24-LS0734P.3
Luckhaupt
4/11/06

AMENDMENT

OFFERED IN THE HOUSE

TO: CSHB 240(), Draft Version "P"

1 Page 2, line 3:

2 Delete "or after 11:00 p.m."

3 Insert "and serving of the product ends no later than 8:00 p.m. [OR AFTER 11:00

4 P.M.]"

#3

w/p

24-LS0734P.1
Finley
3/29/06

AMENDMENT

OFFERED IN THE HOUSE

BY REPRESENTATIVE LEDOUX

TO: CSHB 240(), Draft Version "P"

1 Page 1, line 1:

2 Delete "licensing"

3 Insert "licenses and to winery licenses"

4

5 Page 4, following line 6:

6 Insert new bill sections to read:

7 "* Sec. 6. AS 04.11.140(b) is amended to read:

8 (b) The holder of a winery license may sell wine in quantities of

9 (1) not more [LESS] than five gallons

10 (A) to an individual who is present on the licensed premises; or

11 (B) by shipping to an individual if the shipment is not to an

12 area that has prohibited the importation or possession of alcoholic

13 beverages under this chapter or to an area that has limited the

14 importation or possession of alcoholic beverages unless the sal complies

15 with the limitation;

16 (2) more than five gallons to a person who is licensed under this title,
17 or in another state or country.

18 * Sec. 7. AS 04.11.140(d) is amended to read:

19 (d) The biennial winery license fee is \$100 [\$500]."

Summary of changes to current law by HB 240, proposed by the Brewers Guild of Alaska

CURRENT LAW	2005 PROPOSAL	2006 PROPOSAL
Prohibited financial interest – Holder of a brewery license may not hold a REPL or BDI. Holder of a BDI may obtain one or more brewpub licenses. Holder of a REPL may obtain one Brewpub license.	Breweries and Brewpubs are the same license and may hold one or more REPLs, but may sale beer directly to a maximum of two REPLs or BDIs for each brewery license held, and the two REPLs / BDIs must be specific to each brewery license.	No change to current law.
CURRENT LAW Breweries have no total production cap Brewpubs can only manufacture 150,000 gallons of beer per year.	2005 PROPOSAL No total production for Breweries or Brewpubs.	2006 PROPOSAL No change to current Brewery law Brewpubs can manufacture up to 15,000 bbls per year (465,000 gallons).
CURRENT LAW Breweries sales to a licensed wholesaler are not limited Brewpubs are limited to 15,000 gallons per year or 110% of 2001 sales of this type.	2005 PROPOSAL No limit to wholesale sales for breweries or brewpubs.	2006 PROPOSAL Brewpubs wholesale sales are limited to 1500 bbls (46,500) gallons.
CURRENT LAW Breweries can self distribute Brewpubs can only sell directly to BDIs held by the same owner, maximum of two establishments.	2005 PROPOSAL Breweries and Brewpubs can self-distribute.	2006 PROPOSAL No change to current Brewery law Brewpubs can self-distribute up to 200 bbls per year if located in a community of more than 75,000.
CURRENT LAW Brewery can give free samples of any quantity, but can not sell for on premise consumption Brewpub can give free samples or sell beer for on premise consumption.	2005 PROPOSAL Can provide beer manufactured for consumption on premises with or without charge.	2006 PROPOSAL Breweries can provide samples without charge and if they meet certain requirements they can sell samples. Requirements are (1) Will not sell more than 36 oz per person per day, (2) Will not provide live entertainment, tv's, pool or darts in tasting room, (3) Will not provide seats at counter where beer is served (4) Will operate tasting room only between hours of 9:00 am and 11:00 pm.
CURRENT LAW Can sell up to 5 gallons per individual per day.	2005 PROPOSAL Can sell up to 16 gallons per individual per day.	2006 PROPOSAL No change to current law.
CURRENT LAW Brewpubs with their brewery at a location other than the BDI location are allowed sales to an individual for off premise consumption at the BDI premises only if formerly held brewery and REPL and manufactured beer at location other than the REPL location, in amount of up to five gallons per day per individual.	2005 PROPOSAL Allowed sales of beer manufactured by the brewery to an individual who is present at the REPL or BDI location of the brewery licensee, as specified on the brewery license (see first two issues) of up to 5 gallons per individual per day.	2006 PROPOSAL No change to current law.



4/14/06

Representative Lesli McGuire
Chair, House Judicial
State Capitol, Room 118
Juneau, AK 99801-1182

RE: HB 240, Brewery & Brewpub Licenses

Dear Representative McGuire:

The above referenced bill will change alcohol licensing laws for Brewers and Brewpubs. It also does away with the three-tier system which defines types of licenses in Alaska.

We have met with the Brewers and Brewpubs and decided in order for the majority (Beverage Dispensary Licenses) to agree with the bill, BDL's should also benefit from the licensing changes.

The Anchorage CHARR board members agreed to compromise with the following:

36 ounces for sale at Breweries

Closing at 8pm for Breweries

Delete "tasting rooms" or "rooms" from the bill and replace with licensed establishments

Insert amendment (below) to benefit BDL's

Recommended language by the Anchorage CHARR board to read as follows:

Notwithstanding (a) and (b) of this section, a beverage dispensary licensee or a licensee's agent or employee, or a holder of a general wholesale, wholesale malt beverage and wine licenses by non-resident brewer or the agent or employees of these licensees may provide, without charge, any customer a small sample of beer or wine for promotional purposes.

It was our understanding throughout our negotiations with the brewpubs this would be included in the bill. It has been brought to our attention there is denial by the brewpubs of supporting this amendment and the wholesalers have now backed off on pushing the amendment forward. Frankly, we are tired of the less than honorable approach this group has exhibited throughout the negotiations. We never would have met with the brewpubs and breweries if we knew this was the end goal. If the above amendment is not included in HB240, Anchorage CHARR will oppose this bill.

The issue is simplistic: If the Brewpubs want to brew more beer they should apply for a brewer's license. If the Breweries want to sell individual beer they should apply for a full beverage dispensary license. We have heard the brewpub and brewery excuses and know they are unsubstantiated.


The reality is: It is cheaper and easier to change licensing legislation than it is to purchase the proper license to accomplish goals. This bill with the above amendment is designed to benefit all licensees, not for the profit of a few. What we appear to have is a stalemate and request time for further negotiations regarding our amendment.

Thank you!

Sincerely,

Chuck Edwards
Government Affairs Chair

P.O. Box 111369, Anchorage, AK, 99511, 907 227-3423



Date: April 4, 2006
To: Representative Tom Anderson, Chair
House Labor & Commerce Committee
From: Linda Thomas, Vice President
Alaskan Brewing Co.
Re: Letters of Support from Juneau BDL holders

Representative Anderson,

As a follow-up to your request at last week's hearing regarding the legislation on behalf of the Brewers Guild, enclosed you will find letters from establishments in Juneau that indicate their support for the ability for breweries to sell up to 36 oz. of their samples, plus keeping current law which has no language regarding food restrictions in the legislation.

We have enclosed letters from the following bars/restaurants:

Hangar on the Wharf/Twisted Fish
Doc Water's Pub
Viking Lounge
Triangle Bar

We were unable to get a letter from the Alaskan Bar in a timely manner, but we are continuing to pursue it. If there are other bars/restaurants that you are concerned about, kindly let us know and we will follow-up.

Thank you for your consideration of this legislation that will jointly benefit brewpubs and breweries in Alaska.



ALASKAN
BREWING CO.



Handcrafted at: 5429 Shaun Drive • Juneau, Alaska 99801-9540

Phone: 907.780.5866 • Fax: 907.780.4514 • Web: alaskanbeer.com

Date: 3/31/2006

To: Representative Anderson, Chair
House Labor & Commerce Committee

Re: Support of Breweries Change in Licensing Proposal

We understand that you have asked Alaskan Brewing Company to contact licensees in Juneau and send you a letter on whether we would support a change in the Brewery License statutes. Please consider this our response and support of the Brewer's Guild of Alaska's efforts regarding two specific questions that were raised.

- (1) We understand the breweries want the opportunity to sell up to 36 oz. a day of the brewery's product to a person for consumption on premise. The breweries will have the opportunity to either sell or continue to give away samples as they have done in the past.
- (2) Our understanding is also that the breweries want to keep current law that does not directly prohibit them from food service.

We have been asked specifically to comment on the effect of this proposal and how it relates to our business in Juneau with the largest brewery in the state, Alaskan Brewing Co., located in our town.

We support the breweries efforts to be able to sell their samples if they choose to do so. We do not believe this will cause harm to our establishment in Juneau. We also do not believe that we would be significantly impacted if the law remained quiet as to food service, as is in place with current law.

Should you have any questions, do not hesitate to call. Thank you for the opportunity to comment on this issue.

Signed



Printed Name

Jack Tripp

Establishment

Viking Lounge

Date: 3/31/2006
To: Representative Anderson, Chair
House Labor & Commerce Committee
Re: Support of Breweries Change in Licensing Proposal

We understand that you have asked Alaskan Brewing Company to contact licensees in Juneau and send you a letter on whether we would support a change in the Brewery License statutes. Please consider this our response and support of the Brewer's Guild of Alaska's efforts regarding two specific questions that were raised.

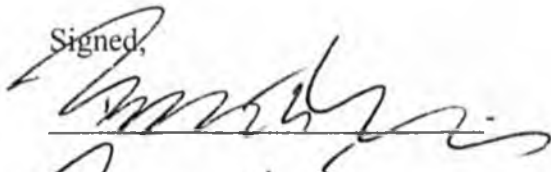
- (1) We understand the breweries want the opportunity to sell up to 36 oz. a day of the brewery's product to a person for consumption on premise. The breweries will have the opportunity to either sell or continue to give away samples as they have done in the past.
- (2) Our understanding is also that the breweries want to keep current law that does not directly prohibit them from food service.

We have been asked specifically to comment on the effect of this proposal and how it relates to our business in Juneau with the largest brewery in the state, Alaskan Brewing Co., located in our town.

We support the breweries efforts to be able to sell their samples if they choose to do so. We do not believe this will cause harm to our establishment in Juneau. We also do not believe that we would be significantly impacted if the law remained quiet as to food service, as is in place with current law.

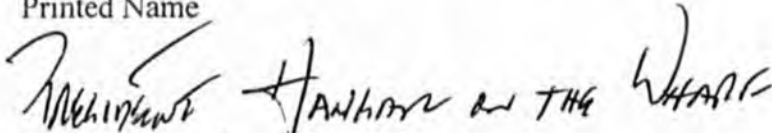
Should you have any questions, do not hesitate to call. Thank you for the opportunity to comment on this issue.

Signed,



FELICIA KILGUS

Printed Name



Establishment

Date: 3/31/2006
To: Representative Anderson, Chair
House Labor & Commerce Committee
Re: Support of Breweries Change in Licensing Proposal

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Should you have any questions, do not hesitate to call. Thank you for the opportunity to comment on this issue.

Signed,



Jason D. Maroney

Printed Name

Dadwater's Pub

Establishment

Date: 3/31/2006
To: Representative Anderson, Chair
House Labor & Commerce Committee
Re: Support of Breweries Change in Licensing Proposal

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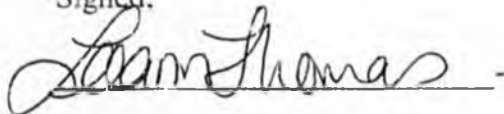
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Should you have any questions, do not hesitate to call. Thank you for the opportunity to comment on this issue.

Signed,



Leeann Thomas

Printed Name

Triangle Club Ince

Establishment

(the law include allowing)

* I would like to see [^]Beverage Dispensary license to give small portions of free samples away.

6 BREWERIES
5 BREWPUB

• ROBERT Mc CORMICK, GLACIER BREWHOUSE

BREWERS GUILD - 6 BREWERIES, 5 BREWPUBS
FBKS, KOZAKI, ANCH

SUPPORTS
VERSION
P

3 TIERS
MANUFACTURE - BREWPUB / BREWERY

DISTRIBUTOR - WHOLESALE

RETAIL - BAR / PACKAGE STORE

• LINDA THOMAS, GM - ALASKAN BREWING CO.

SUPPORTS
VERSION
P

- 67TH BREWERY IN NATION

- NOW OVER 450 BREWERIES

• SILVIA VILAMIDES -
ANCH CHAIR

SUPPORT BUT ① NO FOOD

② CHANGE TIME TO 10 P.M.

③ SOME LEVEL OF LICENSING

④ 24 OUNCES

P.1

• DOUG SKIFFEN

ALCOHOLIC BEV. CONTROL BOARD

- 3 TIER SYSTEM MAY BE COMPROMISED
- GALLONAGE, SIGNIFICANT INCREASE
DIFFICULT FOR NEW BREWERY
TO COMPETE

• GLEN GRADY, SIVER GULCH BREWING

24-LS0734V
Luskhaupt
2/15/06

CS FOR HOUSE BILL NO. 240()
IN THE LEGISLATURE OF THE STATE OF ALASKA
TWENTY-FOURTH LEGISLATURE - SECOND SESSION

BY

Offered:
Referred:

Sponsor(s): HOUSE JUDICIARY COMMITTEE

A BILL

FOR AN ACT ENTITLED

1 **"An Act relating to brewery and brew pub licensing."**

2 **BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:**

3 *** Section 1. AS 04.11.130(c) is amended to read:**

4 (c) The holder of a brewery license may provide samples of the brewery's
5 product, with or without charge, to [PERMIT] a person in quantities of 48 ounces
6 or less a day [TO SAMPLE SMALL PORTIONS OF THE BREWERY'S PRODUCT
7 FREE OF CHARGE] unless prohibited by AS 04.16.030.

8 *** Sec. 2. AS 04.11.135(a) is amended to read:**

9 (a) A brewpub license authorizes the holder of a beverage dispensary license
10 to

11 (1) manufacture on premises licensed under the beverage dispensary
12 license not more than 465,000 [150,000] gallons of beer in a calendar year;

13 (2) sell beer manufactured on premises licensed under the beverage
14 dispensary license for consumption on the licensed premises or other licensed
15 premises of the beverage dispensary licensee that are also licensed as a beverage

1 dispensary;

2 (3) sell beer manufactured on the premises licensed under the beverage
3 dispensary license in quantities of not more than five gallons a [PER] day to an
4 individual who is present on the licensed premises;

5 (4) provide a small sample of the brewpub's beer manufactured on the
6 premises free of charge unless prohibited by AS 04.16.030; [AND]

7 (5) sell beer manufactured on the premises licensed under the beverage
8 dispensary license to a person licensed as a wholesaler under AS 04.11.160; sales
9 under this paragraph may not exceed 46,500 [15,000] gallons or the amount sold under
10 this paragraph in calendar year 2001, plus 10 percent, whichever amount is greater;
11 and

12 (6) sell not more than 200 barrels a year of beer manufactured on
13 the premises to a person who is licensed under this title, or in another state or
14 country.

15 * Sec. 3. AS 04.11.135(d) is amended to read:

16 (d) Notwithstanding (a) of this section, the holder of a brewpub license who,
17 under the provisions of AS 04.11.450(b), formerly held a brewery license and a
18 restaurant or eating place license and who, under the former brewery license,
19 manufactured beer at a location other than the premises licensed under the former
20 restaurant or eating place license may

21 (1) manufacture not more than 465,000 [150,000] gallons of beer in a
22 calendar year on premises other than the premises licensed under the beverage
23 dispensary license;

24 (2) provide a small sample of the manufactured beer free of charge at
25 the location the beer is manufactured unless prohibited by AS 04.16.030; and

26 (3) sell the beer authorized to be manufactured under this subsection

27 (A) on the premises licensed under the beverage dispensary
28 license or other licensed premises of the beverage dispensary licensee that are
29 also licensed as a beverage dispensary;

30 (B) to a wholesaler licensed under AS 04.11.160; sales under
31 this subparagraph may not exceed 46,500 [15,000] gallons or the amount sold

1 under this subparagraph in calendar year 2001, plus 10 percent, whichever
2 amount is greater; [OR]

3 (C) to an individual who is present on the premises described
4 under (A) of this paragraph, or where the beer is manufactured, in quantities of
5 not more than five gallons a [PER] day; or

6 (D) to a person licensed under this title or in another state
7 or country; sales under this paragraph may not exceed 200 barrels a year.

8 * Sec. 4. AS 04.11.135(e) is amended to read:

9 (e) Notwithstanding (a) of this section, a brewpub license authorizes the
10 holder of a restaurant or eating place license to (1) manufacture on premises licensed
11 under the restaurant or eating place license not more than 465,000 [150,000] gallons of
12 beer in a calendar year; (2) sell beer manufactured on premises licensed under the
13 restaurant or eating place license for consumption on the licensed premises; (3) sell
14 beer manufactured on the premises licensed under the restaurant or eating place
15 license in quantities of not more than five gallons a [PER] day to an individual who is
16 present on the licensed premises; and (4) provide a small sample of the brewpub's beer
17 manufactured on the premises free of charge unless prohibited by AS 04.16.030. A
18 person who holds a brewpub license under this subsection may not hold more than one
19 brewpub license.

CS FOR HOUSE BILL NO. 240()

IN THE LEGISLATURE OF THE STATE OF ALASKA

TWENTY-FOURTH LEGISLATURE - SECOND SESSION

BY

Offered:

Referred:

Sponsor(s): HOUSE JUDICIARY COMMITTEE

A BILL

FOR AN ACT ENTITLED

1 **"An Act relating to brewery and brewpub licensing."**

2 **BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:**

3 *** Section 1.** AS 04.11.130(b) is amended to read:

4 (b) The holder of a brewery license may sell beer in quantities of

5 (1) not more [LESS] than five gallons a day to an individual who is
6 present on the licensed premises for consumption off the premises:

7 (2) more than five gallons a day to a person who is licensed under this
8 title, or in another state or country.

9 *** Sec. 2.** AS 04.11.130 is amended by adding a new subsection to read:

10 (e) Unless prohibited by AS 04.16.030, a holder of a brewery license may sell
11 not more than 36 ounces a day of the brewery's product to a person for consumption
12 on the premises if

13 (1) the brewery does not allow live entertainment, televisions, pool
14 tables, or dart games in the room where the consumption occurs;

15 (2) the brewery does not provide seats at the counter or bar where the

1 product is served; and

2 (3) the room where the consumption occurs is not open before 9:00
3 a.m. or after 11:00 p.m.

4 * Sec. 3. AS 04.11.135(a) is amended to read:

5 (a) A brewpub license authorizes the holder of a beverage dispensary license
6 to

7 (1) manufacture on premises licensed under the beverage dispensary
8 license not more than 465,000 [150,000] gallons of beer in a calendar year;

9 (2) sell beer manufactured on premises licensed under the beverage
10 dispensary license for consumption on the licensed premises or other licensed
11 premises of the beverage dispensary licensee that are also licensed as a beverage
12 dispensary;

13 (3) sell beer manufactured on the premises licensed under the beverage
14 dispensary license in quantities of not more than five gallons a [PER] day to an
15 individual who is present on the licensed premises for consumption off the premises;

16 (4) provide a small sample of the brewpub's beer manufactured on the
17 premises free of charge unless prohibited by AS 04.16.030; [AND]

18 (5) sell beer manufactured on the premises licensed under the beverage
19 dispensary license to a person licensed as a wholesaler under AS 04.11.160; sales
20 under this paragraph may not exceed 46,500 gallons in a calendar year, including
21 sales under (6) of this subsection; and

22 (6) sell not more than 6,200 gallons in a calendar year of beer
23 manufactured on the premises to a person who is licensed under this title, or in
24 another state or country, if the premises licensed under the beverage dispensary
25 license are located in a community with a population of 75,000 or more [15,000
26 GALLONS OR THE AMOUNT SOLD UNDER THIS PARAGRAPH IN
27 CALENDAR YEAR 2001, PLUS 10 PERCENT, WHICHEVER AMOUNT IS
28 GREATER].

29 * Sec. 4. AS 04.11.135(d) is amended to read:

30 (d) Notwithstanding (a) of this section, the holder of a brewpub license who,
31 under the provisions of AS 04.11.450(b), formerly held a brewery license and a

1 restaurant or eating place license and who, under the former brewery license,
2 manufactured beer at a location other than the premises licensed under the former
3 restaurant or eating place license may

4 (1) manufacture not more than 465,000 [150,000] gallons of beer in a
5 calendar year on premises other than the premises licensed under the beverage
6 dispensary license;

7 (2) provide a small sample of the manufactured beer free of charge at
8 the location the beer is manufactured unless prohibited by AS 04.16.030; and

9 (3) sell the beer authorized to be manufactured under this subsection

10 (A) on the premises licensed under the beverage dispensary
11 license or other licensed premises of the beverage dispensary licensee that are
12 also licensed as a beverage dispensary;

13 (B) to a wholesaler licensed under AS 04.11.160; sales under
14 this subparagraph may not exceed 46,500 gallons in a calendar year,
15 including sales under (D) of this paragraph; [15,000 GALLONS OR THE
16 AMOUNT SOLD UNDER THIS SUBPARAGRAPH IN CALENDAR YEAR
17 2001, PLUS 10 PERCENT, WHICHEVER AMOUNT IS GREATER; OR]

18 (C) to an individual who is present on the premises described
19 under (A) of this paragraph, or where the beer is manufactured, in quantities of
20 not more than five gallons a [PER] day for consumption off the premises;
21 and

22 (D) to a person licensed under this title, or in another state
23 or country, if the premises where the beer is manufactured are located in
24 a community with a population of 75,000 or more; sales under this
25 subparagraph may not exceed 6,200 gallons in a calendar year.

26 * Sec. 5. AS 04.11.135(e) is amended to read:

27 (e) Notwithstanding (a) of this section, a brewpub license authorizes the
28 holder of a restaurant or eating place license to (1) manufacture on premises licensed
29 under the restaurant or eating place license not more than 465,000 [150,000] gallons of
30 beer in a calendar year; (2) sell beer manufactured on premises licensed under the
31 restaurant or eating place license for consumption on the licensed premises; (3) sell

1 beer manufactured on the premises licensed under the restaurant or eating place
2 license in quantities of not more than five gallons a [PER] day for consumption off
3 the premises to an individual who is present on the licensed premises; and (4) provide
4 a small sample of the brewpub's beer manufactured on the premises free of charge
5 unless prohibited by AS 04.16.030. A person who holds a brewpub license under this
6 subsection may not hold more than one brewpub license.

Alaska State Legislature



House of Representatives House Judiciary Committee

State Capitol, Room 120
Juneau, Alaska 99801-1182
(907) 465-4990

Sponsor Statement HB 240

"An Act relating to brewery and brew pub licensing"

The Brewers Guild of Alaska represents six breweries and five brewpubs operating in the state of Alaska. We are a growing industry that employs hundreds of Alaskans. The Brewers Guild is united in this bill in an effort to foster more equitable competition with breweries and brewpubs from outside of Alaska, while not harming small breweries in Alaska. In the State of Alaska, brewpubs and brewery licenses are exclusive licenses with different competitive markets, although the regular citizen sees no difference in these entities. Both Brewpubs and Brewery Licensees benefit from this bill, but if any of the core content is changed, then there will be an inequitable competitive landscape for either the breweries or the brewpubs.

Brewpubs are legally restricted to sell to consumers for consumption on their licensed premises and, with limitations, to consumers for off-premise consumption and to all other licensees through a distributor. Breweries are legally restricted to sell their product for off-site consumption whether to consumers, wholesalers or other licensees; breweries are also allowed to provide free samples of their product. The proposed legislation is a compromise between these licensees in order to improve the competitive environments of brewpubs and breweries, while not creating a significant impact on the competitive environments of other interested licensees, such as dispensary license owners and distributors.

This legislation increases the amount of beer a brewpub can produce (often referred to as the "production cap") from 150,000 gallons to 465,000 gallons. This cap is based upon the typical industry definition of the top level of production of a "microbrewery." In addition, this legislation increases the amount of beer a brewpub can sell to a licensed wholesaler from 15,000 gallons to 46,500 gallons. Outside brewpubs do not have a cap on the amount of beer they can sell in Alaska.

Current law allows breweries to provide free samples of their products. This legislation allows breweries to also charge for samples as is now common in tasting rooms in other states. Although there have been concerns voiced that this allows breweries to act as "taverns", this legislation includes restrictions that will differentiate the tasting rooms from the "tavern" concept, such as limited on-premise sales of only their beer, restricted hours of operation and a well-defined environment. The sale of samples allows breweries to help defray the costs of on-premise sampling while still providing the promotional and educational aspects of product sampling.

Finally, this legislation allows brewpubs in Anchorage and Fairbanks to self-distribute up to 200 barrels of beer per year. Under current law, brewpubs are required to use a wholesaler to distribute any beer off-premise. However, sales at this level are not necessarily profitable for the wholesaler, so it is difficult for a brewpub to initially get its product to the market. This change could potentially eliminate a competitive advantage to breweries in smaller communities in our state, thus the limitation of a population of 75,000 has been put in place to not harm the smallest of breweries.

The Brewers Guild is in support of this bill in its entirety.

Craig Johnson

From: Ben Millstein/KODIAK ISLAND BREWING CO [bmills@ak.net]
Sent: Tuesday, March 28, 2006 2:00 PM
To: Craig Johnson
Subject: HB 240

Greetings to all interested persons,

As a member of the Brewer's Guild of Alaska running the Kodiak Island Brewing Company, LLC. I would like to express my support for HB240. The Guild has worked long and hard to arrive at a bill that we can all support, and that we believe addresses the concerns of businesses outside our guild. What we propose is in no way unusual when other state laws are examined. Please support this bill, and feel free to call me if you have any questions about it.

Thank you,

Ben Millstein
Manager,
Kodiak Island Brewing Co. LLC



KODIAK ISLAND BREWING CO, LLC
338 SHIELIKOF AVE.
KODIAK, AK. 99615

Representative Tom Anderson, Chair
House Labor and Commerce Committee
Alaska State House

Greetings,

Kodiak Island Brewing Company is a small production brewery which got started in 2003. I am the manager, brewer, accountant, and everything else including an owner, along with many other silent partners. I have a couple part time employees so far, and hope to grow to a level that allows me to hire them full time within the next couple years.

We make fresh, unfiltered beer for local consumption. We do not bottle or ship off island. Our market is small, but over time I hope to gain enough of a share of that market to make a profitable business. Many people comment to me about the added value of Kodiak as a home or destination with a brewery.

The bill we, the Alaska Brewer's Guild, present will make the regulatory climate a little more friendly by unifying the licensing for breweries and brewpubs. For our brewery it will allow us to sell full size kegs for weddings and other large events. It will also allow us to sell open pints at the brewery along with the tastes we can now only give away. I enjoy running a brewery, and hope never to have to make it more complicated to make it profitable, but this bill makes other options easier to consider. If I decide to open a restaurant, this bill would allow me to do so without demanding a full bar type liquor license.

I believe that we all want to make small business and entrepreneurship available and profitable. Simplified regulations are a good start toward that goal.

Thank You,

--Ben Millstein
486-2537
bmilla@ak.net

cc:
Representative Kott
Representative LeDoux
Representative Lynn
Representative Rokcberg
Representative Crawford
Representative Guttenberg



ORSO

Brews Brothers, LLC
737 West 6th Avenue, Anchorage Alaska 99501

April 4, 2005

Representative Tom Anderson
House Labor and Commerce Committee
Alaska State House

RE:HB 240

Dear Representative Anderson,

We are writing to you in support of HB 240, a bill initiated by the Brewers Guild of Alaska, of which we are a member. This bill is our attempt to "level the playing field" for those in the brewing industry and for those who wish to enter the market in the future. HB 240 is the first and only piece of legislation the Brewers Guild of Alaska has supported unanimously.

HB 240 will

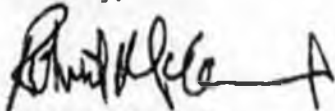
1. Create one type of license for all breweries in the state.
2. Allow current breweries to own Restaurant Eating Place or Beverage Dispensary Licenses as brewpubs can currently.
3. Allow brewpubs to self distribute as breweries can currently.
4. Allow breweries to sell growlers at their restaurants as brewpubs can currently.
5. Eliminate caps on the amount of beer a brewpub can produce.
6. Allow a brewery to sell a keg of beer to an individual present on their premises.

We feel the current caps limiting production are particularly unfair. There are no limits on the amount of beer a brewpub located outside of Alaska can sell in the state of Alaska, but current state law limits the amount an Alaskan brewpub can sell. Beer made in Alaska is only 11% of the Alaska beer market, so we are hardly competing with each other. Last year, Glacier BrewHouse met this cap and was forced by the current law to have our beer produced by a brewery in Washington and shipped back to Alaska to maintain our existing accounts. This moves work and money outside of our state and gives out of state brewpubs more rights to sell in Alaska than an Alaskan brewpub has. This does not seem fair or in the best interest of the state.

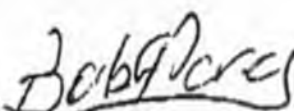
As you know we operate Glacier BrewHouse and ORSO in Anchorage. We employ up to 240 people, with an annual payroll of nearly \$4,000,000. We annually spend approximately \$3,500,000 on product costs, \$500,000 on supplies, and \$1,500,000 in contractual expenses. We paid \$98,500 in Municipal, State and Federal (B.A.T.F.) taxes last year. We have been in business since May of 1996.

I strongly encourage your support of this bill; I look forward to your leadership in this issue and working with you in the passage of this legislation

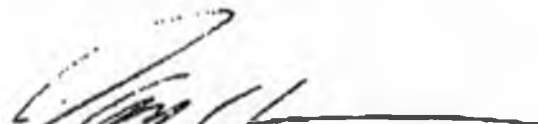
Sincerely,



Robert McCormick
CFO
Glacier BrewHouse/ORSO



Bob Acree
Owner
Glacier BrewHouse/ORSO



Chris Anderson
Managing Partner
Glacier BrewHouse/ORSO

Cc: Representative Kott
Representative LeDoux
Representative Lynn
Representative Rokeberg
Representative Crawford
Representative Guttenberg

Finance Office
3401 Denali St., 202-A
Anchorage, Alaska
99503



Gary J. Klopfer
Member Manager/Owner
Phone: (907) 561-2274
Fax: (907) 562-9354

March 30, 2005

Representative Tom Anderson, Chair
House Labor and Commerce Committee
Alaska State House

Re.: House Bill 240

The Sleeping Lady Brewing Company is a member of the Brewers Guild of Alaska (BGA), which represent a very small cottage industry in the state of Alaska. The BGA is a small group, however, its impact on our towns and the state of Alaska are rather substantial. Combined the BGA members directly employ hundreds of Alaskans, with payrolls in the millions of dollars. Its members buy millions of dollars in supplies from local vendors, thus creating many more indirect jobs. As members, we have spent millions of dollars on new construction and remodeling older buildings for our operations. We pay tens of thousands of dollars in property and industry taxes. And, we have done all this without asking for any state assistance or without harming any other business or industry.

We are proposing to change the regulations that govern our industry because, quite frankly, they have become so convoluted and twisted by either infighting or pressured from outside industrial forces, that they do not represent the state of our industry today or where we might be in the future. These regulations were mainly put into place to restrict our growth potential, impede our progress and possibly to protect other industries. However, before we address these issues, we would like to look back to see how we got to where we are today.

There was a "brewpub" law on the books since 1993. Unfortunately, this law did not make any economic sense and as Adam Smith's, "Invisible Hand" dictates, there were no brewpubs in Alaska. In 1995, some of us in the Guild wanted to make beer in Alaska and serve food. The only way to accomplish this was to obtain a "brewery license" and a "restaurant or eating place license." We got the licenses, preceded ahead and before we were even done with construction, the regulations were changed to make this activity illegal! Why? Because other "beverage dispensary license holders" thought we had some kind of a loop hole and that we would put them out of business or make their license less valuable. Next, over the course of many years, came a series of quantity limits and who could do what, when and where regulations (mainly brought on by ourselves, unfortunately). These laws have been repeatedly changed and modified based on conjecture and fear and not on economic fact.

Now, why do we feel that it is necessary to change our regulations? Fortunately, our industry has a ten year track record to look at and see what has transpired during this time. The implied fact that "beverage dispensary license holders" would be harmed has proven to be groundless. It takes just as much money, if not more, to operate a "brewery license" and a "restaurant or eating place license" than it does to just buy a "beverage dispensary license". In fact, many of us have since purchased a "beverage dispensary license" because we felt it was in the best interest of our customers. We, the Guild members, have looked long and hard in the mirror and have realized that it is in our own best interest to compete openly and fairly with each other by removing the artificial barriers and creating a level playing field. Our industry has had a positive impact for our communities and our state. The changes we propose will simplify the regulations which will help our industry grow, expand on our "Made in Alaska" products and create more job opportunities for Alaskans!

Thank you for taking your time to read my letter and please support HB 240.

Sincerely,

Gary J. Klopfer

cc Representative Kott
Representative LeDoux
Representative Lynn
Representative Rokeberg
Representative Crawford
Representative Guttenberg



717 West Third Avenue, Anchorage, Alaska 99501 (907) 277-7777 www.alaskabeers.com

HB

242

Alaska Department of Labor and Workforce Development
Comparison of State Penalties
CSHB 242(F)
State Unemployment Tax Avoidance

Oregon Penalties

References: Laws of Oregon (657.430, 657.480 & 657.990)

Passed Legislation Relating to transfer of experience rating for unemployment taxes; creating new provisions; and amending ORS 657.430, 657.480 and 657.990.

SECTION 2. ORS 657.480 is amended to read:

657.480.3(a) If a person knowingly engages in activity to transfer or acquire, or to attempt to transfer or acquire, a trade or business or any portion of a trade or business solely or primarily for the purpose of obtaining a lower tax rate, the director shall assign the person the highest tax rate designated under this chapter for the rate year during which the activity occurred and for the next three rate years. However, if the person is already subject to the highest tax rate for a year, or if the amount of increase in the person's tax rate would be less than two percentage points for the year, the director shall impose an additional penalty tax rate of two percentage points added to the calculated tax rate.

(b) A person may not advise another person to engage in activity to transfer or acquire, or to attempt to transfer or acquire, a trade or business or any portion of a trade or business solely or primarily for the purpose of obtaining a lower tax rate. In addition to any other penalty provided by law, the director may assess a civil penalty not to exceed \$10,000 against a person that knowingly advises another person to engage in activity to transfer or acquire, or to attempt to transfer or acquire, a trade or business or any portion of a trade or business solely or primarily for the purpose of obtaining a lower tax rate.

SECTION 3. ORS 657.990 is amended to read:

(3) Violation of ORS 657.480 (3)(a) or (b) is a Class C felony.

Idaho Penalties

References: Laws of Idaho: (72-1351A and 18-112)

72-1351A. FEDERAL CONFORMITY PROVISIONS REGARDING TRANSFERS OF EXPERIENCE AND ASSIGNMENT OF RATES. Notwithstanding any other provision of this chapter, the following shall apply regarding transfers of experience and assignment of rates:

(3) (a) It shall be a violation of this section if a person:

(i) Makes any false statement to the department when the maker knows the statement to be false or acts with deliberate ignorance of or reckless disregard for the truth of the matter or willfully fails to disclose a material fact to the department in connection with the transfer of a trade or business;

(ii) Prepares any false or antedated report, form, book, paper, record, written instrument, or other matter or thing in connection with the transfer of a trade or business with the intent to submit it or allow it to be submitted to the department as genuine or true;

(iii) Knowingly violates or attempts to violate subsection (1) or (2) of this section or any other provision of this chapter related to determining the assignment of a contribution rate or an experience rate; or

(iv) Knowingly advises another person in a way that results in a violation or an attempted violation of subsection (1) or (2) of this section or any other provision of this chapter related to determining the assignment of a contribution rate or an experience rate.

(b) If a person commits any of the acts described in paragraph (a) of this subsection (3), the person shall be subject to the following penalties:

(i) If the person is a covered employer, a civil money penalty of ten percent (10%) of such person's taxable wages for the four (4) completed consecutive quarters preceding the violation shall be imposed for such year and said penalty shall be deposited in the state employment security administrative and reimbursement fund as established by section 72-1348, Idaho Code.

(ii) If the person is not a covered employer, such person shall be subject to a civil money penalty of not more than five thousand dollars (\$5,000) for each violation. Any such penalty shall be deposited in the state employment security administrative and reimbursement fund as established by section 72-1348, Idaho Code.

(4) Every person who knowingly makes any false statement to the department or knowingly fails to disclose a material fact to the department in connection with the transfer of a trade or business, or knowingly prepares any false or antedated report, form, book, paper, record, written instrument, or other matter or thing in connection with the transfer of a trade or business with the intent to submit it or allow it to be submitted to the department as genuine or true, or knowingly violates or attempts to violate subsection (1) or (2) of this section or any other provision of this chapter related to determining the assignment of a contribution rate or an experience rate, or knowingly advises another person to act in a way that results in a violation or an attempted violation of subsection (1) or (2) of this section or any other provision of this chapter related to determining the assignment of a contribution rate or an

experience rate, shall be guilty of a felony punishable as provided in section 18-112, Idaho Code.

18-112. PUNISHMENT FOR FELONY. Except in cases where a different punishment is prescribed by this code, every offense declared to be a felony is punishable by imprisonment in the state prison not exceeding five (5) years, or by fine not exceeding fifty thousand dollars (\$50,000), or by both such fine and imprisonment.

Nevada Penalties

References: Laws of Nevada (612.730, 193.130)

Assembly Bill No. 502-Committee on Commerce and Labor

CHAPTER.....

THE PEOPLE OF THE STATE OF NEVADA, REPRESENTED IN
SENATE AND ASSEMBLY, DO ENACT AS FOLLOWS:

Section 1. Chapter 612 of NRS is hereby amended by adding thereto a new section to read as follows:

1. The Administrator shall adopt regulations establishing procedures to identify:

(a) Transactions in which the transfer or acquisition of a business entity is for the sole or primary purpose of obtaining a lower unemployment insurance contribution rate; and

(b) Common ownership, management or control between two or more business entities, including, without limitation, through the movement of workforce between such business entities.

2. If, for any rate year, the Administrator determines that an employer has, through deliberate ignorance, reckless disregard, intent to evade, fraud, misrepresentation or willful nondisclosure, obtained or attempted to obtain a more favorable rate of contribution, the Administrator shall assign to the employer the maximum contribution rate plus 2 percent for each applicable rate year, the current rate year and the subsequent rate year. In addition to any penalty imposed pursuant to NRS 612.730, the Administrator shall impose on the employer a civil penalty of the greater of:

(a) Five thousand dollars; or

(b) Ten percent of the total amount of any resulting underreporting of contributions and any other penalties and interest imposed.

3. If the Administrator determines that a person or business entity knowingly advised another person or business entity to violate or attempt to violate any provision of this chapter, in addition to any penalty imposed pursuant to NRS 612.730, the Administrator shall impose on such person or business entity a

civil penalty of the greater of:

- (a) Five thousand dollars; or
- (b) Ten percent of the total amount of any resulting underreporting of contributions and any other penalties and interest imposed.

Sec. 18. NRS 612.730 is hereby amended to read as follows:

612.730 1. Any employing unit or any officer or agent of an employing unit or any other person who makes a false statement or representation knowing it to be false, or who knowingly fails to disclose a material fact, to prevent or reduce the payment of benefits to any natural person entitled thereto, or who willfully fails or refuses to make any such contributions or other payment or to furnish any reports required by this chapter, or to produce or permit the inspection or copying of records as required by this chapter, is guilty of a misdemeanor.

2. Any employing unit, or any officer or agent of an employing unit or any other person who knowingly:

- (a) Attempts to use a plan or scheme to avoid becoming or remaining subject to the provisions of this chapter or to reduce any contribution or other payment required pursuant to the provisions of this chapter; or

- (b) Advises an employing unit to use a plan or scheme to avoid becoming or remaining subject to the provisions of this chapter or to reduce any contribution or other payment required pursuant to the provisions of this chapter, is guilty of a category C felony and shall be punished as provided in NRS 193.130.

NRS 193.130 Categories and punishment of felonies.

1. Except when a person is convicted of a category A felony, and except as otherwise provided by specific statute, a person convicted of a felony shall be sentenced to a minimum term and a maximum term of imprisonment which must be within the limits prescribed by the applicable statute, unless the statute in force at the time of commission of the felony prescribed a different penalty. The minimum term of imprisonment that may be imposed must not exceed 40 percent of the maximum term imposed.

2. Except as otherwise provided by specific statute, for each felony committed on or after July 1, 1995:

- (c) A category C felony is a felony for which a court shall sentence a convicted person to imprisonment in the state prison for a minimum term of not less than 1 year and a maximum term of not more than 5 years. In addition to any other penalty, the court may impose a fine of not more than \$10,000, unless a greater fine is authorized or required by statute.

California Penalties

References: Laws of California (1051, 2117, 2117.5, 2112)

2101.5. It is a violation of this chapter to willfully make a false statement or representation or knowingly fail to disclose a material fact for the purpose of lowering or avoiding any contribution required of the maker or other person, or to avoid becoming or remaining subject to this division.

2101.6. (a) It is a violation of this chapter for any person to procure, counsel, advise, or coerce anyone to willfully make a false statement or representation, or to knowingly fail to disclose a material fact in order to lower or avoid any contribution or to avoid being or remaining subject to this division.

(b) It is a violation of this chapter for any person to willfully aid or assist anyone in making a false statement or representation, or in knowingly failing to disclose a material fact, in order to lower or avoid any contribution, or to avoid being or remaining subject to this division.

2102. (a) It is a violation of this chapter for any person residing in this state to willfully make a false statement or representation or knowingly fail to disclose a material fact to obtain or increase benefits or payments under the provisions of the unemployment insurance law of any other state.

(b) Nothing in this section shall be construed to preclude the applicability of Section 470 of the Penal Code to any acts or omissions which violate this section.

2117. Any person who, with or without intent to evade any requirement of this code or any lawful requirement of the department under this code, fails to file any return or report, or to supply any information required by this code or who, with or without like intent, makes, renders, signs, or verifies any false or fraudulent return, report, or statement, or supplies any false or fraudulent information, is liable for a civil penalty of not more than one thousand dollars (\$1,000), and is also guilty of a misdemeanor and shall, upon conviction, be fined an amount not to exceed one thousand dollars (\$1,000), or be imprisoned for not more than one year, or both the fine and imprisonment, at the discretion of the court.

2117.5. Any person who, within the time required by this code, willfully fails to file any return or report, or to supply any information with intent to evade any tax imposed by this code, or who, willfully and with like intent, makes, renders, signs, or verifies any false or fraudulent return, report, or statement or supplies any false or fraudulent information, is punishable by imprisonment in the county jail not to exceed one year, or in the state prison, or by a fine of not

more than twenty thousand dollars (\$20,000), or by both the fine and imprisonment, at the discretion of the court.

2122. Except as provided in Sections 2117, 2117.5, 2118, and 2118.5, a violation of this chapter is punishable by imprisonment in the county jail not to exceed one year, or in the state prison, or by a fine of not more than twenty thousand dollars (\$20,000), or by both the fine and imprisonment, at the discretion of the court.

Arizona Penalties

References: Laws of Arizona (23-733, 23-733.01, 13-2310, 13-2311)

23-733.01. Assignments of rates; transfers of experience; violation; civil penalty; definitions

C. If an employer or a person knowingly violates or attempts to violate this section for the purpose of obtaining a lower rate of contribution or if a person knowingly advises an employer or a person on evading or defeating a contribution or its payment, the person or employer shall be subject to the following penalties:

1. If the person is an employer, the person shall be assigned the highest rate assignable under this chapter for the rate year in which the transfer or the attempted transfer occurred and for the following three rate years. If the person's business is already at the highest rate for any year, or if the amount of increase in rate would be less than two per cent for any year, the contribution penalty rate of two per cent of taxable wages shall be imposed for any such year.

2. If the person is not an employer, the department shall assess against the person a civil penalty of five thousand dollars. The department shall deposit penalties collected pursuant to this paragraph in the penalty and interest account pursuant to section 23-705.

3. Any person or employer in violation of this section may also be prosecuted pursuant to section 13-2310 or 13-2311. This does not preclude prosecution pursuant to section 23-786.

13-2310. Fraudulent schemes and artifices; classification; definition

A. Any person who, pursuant to a scheme or artifice to defraud, knowingly obtains any benefit by means of false or fraudulent pretenses, representations, promises or material omissions is guilty of a class 2 felony.

B. Reliance on the part of any person shall not be a necessary element of the offense described in subsection A of this section.

C. A person who is convicted of a violation of this section that involved a benefit with a value of one hundred thousand dollars or more is not eligible for suspension of sentence, probation, pardon or release from confinement on any basis except pursuant to section 31-233, subsection A or B until the sentence imposed by the court has been served, the person is eligible for release pursuant to section 41-1604.07 or the sentence is commuted.

D. The state shall apply the aggregation prescribed by section 13-1801, subsection B to violations of this section in determining the applicable punishment.

E. As used in this section, "scheme or artifice to defraud" includes a scheme or artifice to deprive a person of the intangible right of honest services.

13-2311. Fraudulent schemes and practices; willful concealment; classification

A. Notwithstanding any provision of the law to the contrary, in any matter related to the business conducted by any department or agency of this state or any political subdivision thereof, any person who, pursuant to a scheme or artifice to defraud or deceive, knowingly falsifies, conceals or covers up a material fact by any trick, scheme or device or makes or uses any false writing or document knowing such writing or document contains any false, fictitious or fraudulent statement or entry is guilty of a class 5 felony.

Washington Penalties *(additional legislation pending)*

References: Laws of Washington (RCW 50.29.062, 50.36.010, 50.36.020)

RCW 50.36.010 Violations generally

It shall be unlawful for any person to knowingly give any false information or withhold any material information required under the provisions of this title. Any person who violates any of the provisions of this title which violation is declared to be unlawful, and for which no contrary provision is made, shall be guilty of a misdemeanor and shall be punished by a fine of not less than twenty dollars nor more than two hundred and fifty dollars or by imprisonment in the county jail for not more than ninety days: PROVIDED, That any person who violates the provisions of RCW 50.40.010 shall be guilty of a gross misdemeanor.

Any person who in connection with any compromise or offer of compromise willfully conceals from any officer or employee of the state any property belonging to an employing unit which is liable for contributions, interest, or penalties, or receives, destroys, mutilates, or falsifies any book, document, or

record, or makes under oath any false statement relating to the financial condition of the employing unit which is liable for contributions, shall upon conviction thereof be fined not more than five thousand dollars or be imprisoned for not more than one year, or both.

The penalty prescribed in this section shall not be deemed exclusive, but any act which shall constitute a crime under any law of this state may be the basis of prosecution under such law notwithstanding that it may also be the basis for prosecution under this section.

RCW 50.36.020 Violations by employers

(1) Any person required under this title to collect, account for and pay over any contributions imposed by this title, who willfully fails to collect or truthfully account for and pay over such contributions, and any person who willfully attempts in any manner to evade or defeat any contributions imposed by this title or the payment thereof, is guilty of a gross misdemeanor and shall, in addition to other penalties provided by law, upon conviction thereof, be fined not more than five thousand dollars, or imprisoned for not more than one year, or both, together with the costs of prosecution.

Hawaii Penalties

References: Laws of Hawaii (383-66)

Any employing unit who knowingly violates the law will be subject to the highest tax rate for the current and following 3 years. If the employing unit is already at the highest tax rate or if the amount of the rate increase is less than 2%, a penalty equal to contributions of 2% of taxable wages will be imposed for the current and following 3 years. Any person who is not an employer who knowingly violates or provides SUTA dumping advice may be subject to a civil penalty of up to \$5,000. In addition, a criminal misdemeanor charge with a fine of up to \$10,000 may be imposed for each false statement or violation of the law and each day may be considered to be a separate offense.

24-LS0821V
Wayne
1/27/06

CS FOR HOUSE BILL NO. 242()
IN THE LEGISLATURE OF THE STATE OF ALASKA
TWENTY-FOURTH LEGISLATURE - SECOND SESSION

BY

Offered:
Referred:

Sponsor(s): REPRESENTATIVE CRAWFORD

A BILL

FOR AN ACT ENTITLED

1 "An Act requiring an employing unit with a change in ownership, management, or
2 control or similar change to notify the Department of Labor and Workforce
3 Development of the ownership change; relating to the unemployment contribution rate
4 of an employing unit; defining 'business' for purposes of statutes setting unemployment
5 contribution rates; establishing the crime of obtaining an unemployment rate by
6 deception; and providing for an effective date."

7 **BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:**

8 * Section 1. AS 23.20 is amended by adding a new section to read:

9 **Sec. 23.20.293. Requirement to notify the department of a business change**
10 **and acquisitions.** (a) An employing unit that has a change in ownership, management,
11 or control, or that succeeds to or acquires all or part of another employing unit's trade
12 or business, shall notify the department in writing in accordance with regulations
13 adopted by the department.

1 (b) For the purposes of this section, "a change in ownership, management, or
2 control" means a change of person, entity, or responsible party required by law to pay
3 unemployment insurance contributions.

4 * Sec. 2. AS 23.20.295(d) is amended to read:

5 (d) This section does not apply to an acquisition, transfer of a trade or
6 business, or transfer of an employers' workforce conducting the trade or business
7 if the acquisition or transfer is determined by the commissioner

8 (1) to have been primarily for the purpose of obtaining a more
9 favorable rate of contributions under AS 23.20.280 - 23.20.310,

10 (2) to be inequitable to the parties, [OR]

11 (3) to be contrary to the public interest, or

12 (4) to be a violation of 42 U.S.C. 503(k) (SUTA Dumping
13 Prevention Act of 2004).

14 * Sec. 3. AS 23.20 is amended by adding a new section to read:

15 **Sec. 23.20.297. Special standards addressing transfers of experience and**
16 **assignment of rates.** (a) The following standards apply regarding assignment of rates
17 and transfers of experience. For the purposes of AS 23.20.295(d)(1) and (4),

18 (1) if an employer transfers its trade or business, its workforce
19 conducting the trade or business, or a portion of that trade, business, or workforce, to
20 another employer and, at the time of the transfer, there is substantially common
21 ownership, management, or control of the two employers, then the unemployment
22 experience attributable to the transferred trade, business, or workforce is transferred to
23 the employer to whom that trade, business, or workforce is transferred; the rates of
24 both employers are recalculated and made effective immediately upon the date of the
25 transfer;

26 (2) if a person is not an employer at the time the person acquires the
27 trade, business, or workforce of an employer, the unemployment experience of the
28 acquired trade, business, or workforce may not be transferred to that person if the
29 commissioner finds that the person acquired the trade, business, or workforce in order
30 to obtain a lower rate of contributions; instead, the person is assigned the applicable
31 new employer rate under AS 23.20.170(b).

1 (b) An employer who knowingly or recklessly violates or attempts to violate,
2 or who advises another employer to violate, (a) of this section or any other provision
3 of this chapter related to determining the assignment of a contribution rate, or fails to
4 notify the department of a trade, business, or workforce change or acquisition in order
5 to obtain a more favorable rate of contributions, is not eligible for a rate determination
6 under AS 23.20.280 - 23.20.310. The employer shall pay one of the following as
7 assigned by the department:

8 (1) contributions at the highest rate provided for the rate year of the
9 violation and for the three succeeding rate years; or

10 (2) if the employer's trade, business, or workforce is already at the
11 highest rate for the rate year of the violation, contributions at the highest rate for the
12 three succeeding rate years and a cash penalty of two percent of taxable wages for the
13 rate year of the violation and three succeeding rate years.

14 (c) A person who knowingly or recklessly advises another person or employer
15 to transfer or acquire a trade, business, or workforce under the provisions of this
16 section in order to obtain a more favorable rate of contributions in violation of (a) of
17 this section is subject to a civil penalty of not more than \$5,000.

18 (d) The department may interpret and apply this section in such a manner as to
19 meet the minimum requirements by the United States Department of Labor.

20 * Sec. 4. AS 23.20 is amended by adding a new section to read:

21 **Sec. 23.20.299. Obtaining an unemployment contribution rate by**
22 **deception.** (a) A person who violates AS 23.20.297(b) or (c) commits the crime of
23 obtaining an unemployment contribution rate by deception.

24 (b) A person commits the crime of obtaining an unemployment contribution
25 rate by deception in the first degree if the value of the difference between the rate that
26 had been assigned to the trade, business, or workforce and the rate assigned as a result
27 of the violation is \$25,000 or more. Obtaining an unemployment contribution rate by
28 deception in the first degree is a class B felony.

29 (c) A person commits the crime of obtaining an unemployment contribution
30 rate by deception in the second degree if the value of the difference between the rate
31 that had been assigned to the trade, business, or workforce and the rate assigned as a