Surviving the Wine War

The paper is the summary of the book “Wine Economics” (in Italian) just published for Bocconi University Press and with preface by Orley Ashenfelter.

Methods

Review of the literature on wine economics and policy with six policy suggestions to survive the wine war

Results

Six relevant policy measure are identified to survive in this competitive market, from quality and reputation to consumption and tax incentives to promote quality

Abstract

This article provides an overview of the world wine market in a historical perspective, showing trends and determinants of both demand (consumption) and supply (production and export) of wine around the world, highlighting the dynamics and policies that have occurred over time, and analyzing the differences between these two groups of countries and the respective strengths and weaknesses. After a review of the determinants of wine consumption, quality and price, we will move to competition and profitability in the wine sector and the differences between the types of existing firms, classified by mission/objectives and legal nature and with a special focus on cooperative enterprises. Wine and finance concludes the first part of the program: we will analyze, in comparison to other assets, the risk and the return of wines bought at auctions (clearly considering the purchase of premium bottles and stocks of large wineries), then we will evaluate the benefits – in terms of diversification, risk and return – coming from the inclusion of wine into a portfolio of assets. A final lesson describes the use of derivatives in the wine sector and their insurance potential. The second part of the paper deals with the issue of market regulation performed by public authorities (national or supranational like the European Union). In fact, the market left to itself is often unable to determine a Pareto-optimal resources allocation. We will start this section by describing the market failures due to the asymmetric information between producer and buyer which led the governments to create a classification system based on four levels.
(in Italy, in decreasing quality order, DOCG, DOC, IGT and table wine) and companies to create associations/consortia to create collective brands (appellations/denominations). We will review the most important contributions to the topic of individual reputation (of the wineries), collective reputation (of appellations/denominations) and institutional reputation (the classification system). Then, we will study the externalities - positive and negative - arising from the production and consumption of wine (and alcohol in general) and discuss the main tools used by public authorities in order to prevent or punish harmful or illegal behaviors connected to the alcohol abuse. Finally, we will describe the economic policies put in place by the European public authorities to influence the supply of wine, adapt it to domestic demand and restore the market equilibrium.

The conclusions identify the six key variables to survive the so-called “wine war” while, at the same time, protecting public health: (i) quality of the products, (ii) marketing and clear system of classification of wines; (iii) economies of scale and competitive prices; (iv) promotion of the wine culture among consumers; (v) changes to the tax system; (vi) variety of native grapes.

1. Quality of products. Over the past decades there has been a steady increase in the quality of the wine produced all over the world and a parallel increase in consumers’ expectations and skills. In such a competitive market producing poor wines is hardly sustainable. Coalitions of producers aimed at protecting wine appellations of origin should constantly improve the minimum quality standards without lowering them during a downturn to achieve short-term benefits which would disappear soon because of a declining reputation;

2. Marketing and clear wine classification system. The perceived quality is, however, more important than the actual one since it is the former one that directly influences the consumers’ purchasing decisions and their willingness to pay. Marketing campaigns are fundamental in order to impose the corporate brand and affect sales, but they remain the prerogative of large groups which in the Old World - and especially in Italy - are a small minority. For this reason, the funds awarded by the European Union to the coalition of producers (consortia) to promote outside Europe the European wine and the collective brands/appellations are - if well managed - an important instrument of industrial policy. The wine classification system, if properly regulated, can mitigate information asymmetries between producers and consumers by allowing smaller companies - which do not have the financial resources necessary to build a solid reputation at the individual level - to benefit from the reputation of a prestigious collective brand without incurring high costs. Over the last years, the system of the AOC/DOC has been criticized because of the excessive number of denominations that in Italy sometimes even overlap geographically (e.g. DOCG Chianti/DOCG Chianti Classico; DOC Prosecco/DOCG Prosecco di Conegliano and Valdobbiadene, etc.). Stallcup (2005), rightly observes that “the traditional approach to wine education has been and continues to be too complex for non-experts. The vast majority of consumers just want to be able, from time to time, to buy a good bottle of wine without having to take a course in stochastic calculus or theoretical physics in the French language”. Other people report a weak correlation between hierarchical category (e.g. DOCG, DOC) and product quality, as well as the increasing share of wine classified as excellent. In this way it ends up being a useless signal. It is necessary, therefore, to eliminate those appellations/denominations which have a small number of producers (unless they are a pearl in the national scenario) and devise a system that can prevent, on the one hand, that a growing share of wine gets classified as excellence and, on the other, that - like a noble title - the membership to the highest segment no longer reflects the actual hierarchy of quality, perpetuating the status quo. The downgrading, therefore, should not be a theoretical and remote but rather a real and frequent chance like in a football league. This would allow other wines to level up and, at the same time, avoid overcrowding in the top segment (reached shouting “todos caballeros”) which over time would slowly destroy the information content of the label;

3. Economies of scale and competitive prices. Premium wines - which can be sold at high prices - represent a minority of the world's wine. Common wines are generally of medium or low quality level and are bought by clients who are very sensitive to the quality/price ratio, if not only to the price. The price largely reflects the structure of the average production costs, which in turn are an inverse function of the economies of scale: larger companies have greater bargaining power when purchasing the production inputs and can achieve a better organizational efficiency which results in lower average costs. The average size of European - and especially Italian - companies is much lower than that of the New World. This ensures on the one hand a wide variety of products, but on the other hand it implies a competitive disadvantage on the cost and, sometimes, even on the
quality side since the adoption of certain machineries and treatments may be too expensive for small businesses. From this point of view cooperatives play a vital role by unifying a production potential dispersed among hundreds or thousands of individuals with plots of land which are too small to survive in the market. Their task is to constantly improve the product quality, identifying internal management rules that can minimize the risk of opportunistic behavior by their members. Public authorities, however, should encourage with appropriate tax incentives the process of aggregation among small companies in order to make them competitive and survive;

4. Promotion of wine culture among consumers. The imbalance between supply and demand of wine in Mediterranean countries is not caused by the production growth - which actually has been declining for decades - but rather by the collapse of the domestic consumption. The response of the European Union consisted of a series of policies aimed at restoring the equilibrium by encouraging, on the one hand, exports outside Europe and, on the other, by restricting the production. These attempts have largely been unsuccessful because the instruments adopted have often generated the opposite effect and, especially, because it was not possible to restrict the production of non-European countries. With an almost stationary population and a per capita consumption which in Mediterranean countries has been falling by 50-70% in less than half a century, the authorities tried to act only from the supply side completely neglecting the demand side. Governments should, instead, adopt a national plan of wine education to make young people fall in love again with this drink. Obviously, the associations of sommeliers (in Italy AIS, FISAR and FIS) should be actively involved. The goal, always subject to the protection of public health and without increasing the total consumption of alcohol, should be to increase the consumers’ willingness to pay and reverse the process of substitution between wine and beer. It is weird and unacceptable that in countries with ancient winemaking tradition such as Italy and Spain, beer is becoming more "trendy" than wine. Wine tasting courses should be held in early adulthood and should include a module on health, taught by qualified medical staff, outlining the benefits of moderate consumption and the damages of alcohol abuse. Moderate drinking - and not gobbling crazily - must be the consumption model of the young since they achieve the minimum legal drinking age, because the wrong behaviors are dragged over the lifetime with serious consequences for health. Awareness campaigns like “Wine in Moderation” are not only ineffective in terms of results achieved, but also conceptually wrong. In fact, limiting the slogan only to wine ends up damaging the image of this drink, which moreover plays a marginal role in binge drinking and road deaths. It would, therefore, be advisable to modify the slogan into “Alcohol in Moderation” and divert the resources towards training programs set as mentioned above. It is also necessary to develop a serious public transportation system (metro, bus, taxi) to allow individuals to leave the car at home. Anticipating the closure time of night clubs or stopping the sale of alcoholic beverages at midnight cannot be the solution to the Saturday night’s deaths. In doing so the government tries to conceal with prohibitionist policies its inability to offer services and solutions to its citizen. It is like if to a patient who limps, a doctor gave a crutch because unable to cure the leg: better to change doctor! The wine tasting courses held by professional sommeliers should be supported abroad through cultural centers and the embassies in order to increase the reputation of the domestic wines, thereby encouraging the buyers’ loyalty and the exports of quality wines. All these measures should, finally, be accompanied by the promotion of wine roads and by economic incentives to the renovation of cellars by famous architects in order to promote wine tourism, which has a huge and largely unexploited potential (at least in Italy...);

5. Changes to the tax system. Alcoholic beverages are subject to two types of taxation: on the amount of alcohol (excise) and on the value charged (ad valorem). Excise duties help increase quality because – under the assumption that the best products are more expensive - their relative weight decreases with quality, while ad valorem taxes do not alter relative prices between products of different quality. If the government, then, wants to raise the quality of products, then it may be appropriate to shift the tax burden from VAT to excise duties, leaving unchanged the total fiscal burden;

6. Variety of the native grapes. New World countries are very competitive from the cost side and, often, also from that of quality, but since they do not have native vines they are forced to plant international varieties grown successfully all over the world. Therefore, they have no chance to differentiate themselves, unlike Old World countries which have hundreds of native varieties in addition to those adopted internationally. The variety of grapes is a strength when customers are sophisticated and curious, but can be a barrier to inexperienced buyers who get lost into a jungle of vines and denominations that have never heard of before. Argentina, which by many
consumers is closely associated with Malbec - French grape that has found its ideal terroir overseas - is the counterexample of a country that has built its success