

## GAMBLING ON THE FUTURE: SHOULD CALIFORNIA PRIVATIZE THE STATE LOTTERY?

In conjunction with his May Revision to the 2007-08 Proposed Budget, the Governor proposes to privatize the California lottery. The Governor suggests that the lottery could be leased on a long-term basis to a private contractor for a one-time payment of up to \$37 billion.<sup>1</sup> Documents prepared by investment bankers suggest that the state could receive \$13 billion to \$18 billion from a long-term lease. In addition to promising that public education would receive, at a minimum, “the same dollar level of funding that it received in the highest year of lottery funding,” the Governor states that proceeds from the lease should be used to pay down the state’s debt.<sup>2</sup> The Governor’s proposal assumes that a private contractor could significantly increase lottery ticket sales. This *Budget Brief* examines whether the California lottery is, in fact, underperforming; whether privatization is necessary to increase lottery sales; and policy issues raised by the Governor’s proposal.

### Where Did the Lottery Come from and What Does It Support?

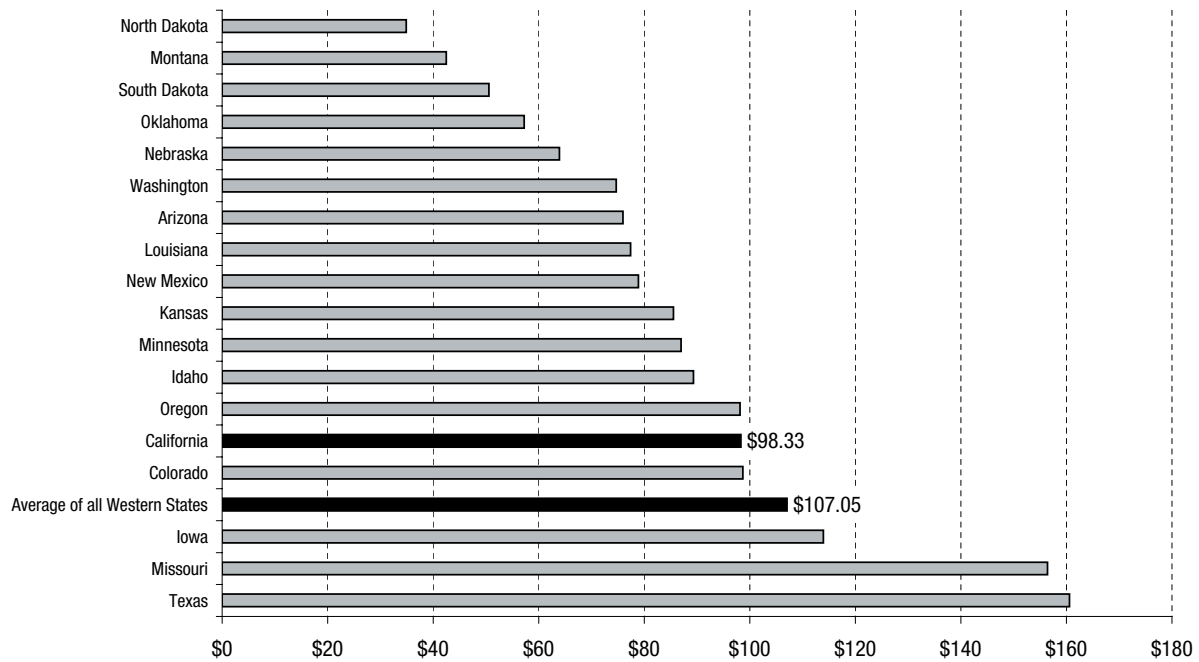
Proposition 37, the California State Lottery Act passed by voters in 1984, established the California lottery. The Act requires that lottery proceeds be divided between prizes (50 percent), administration (no more than 16 percent), and public schools (at least 34 percent).

Lottery funds are allocated annually on a per student basis to K-12 and community college districts, the California State University, the University of California, and other educational institutions. Most lottery funds allocated to education go to K-12 and community college districts. In 2005-06, elementary and secondary schools received eight out of every 10 lottery fund dollars (80.8 percent) and community colleges received approximately one out of seven lottery fund dollars (14.2 percent).<sup>3</sup>

### Is the Lottery Underperforming?

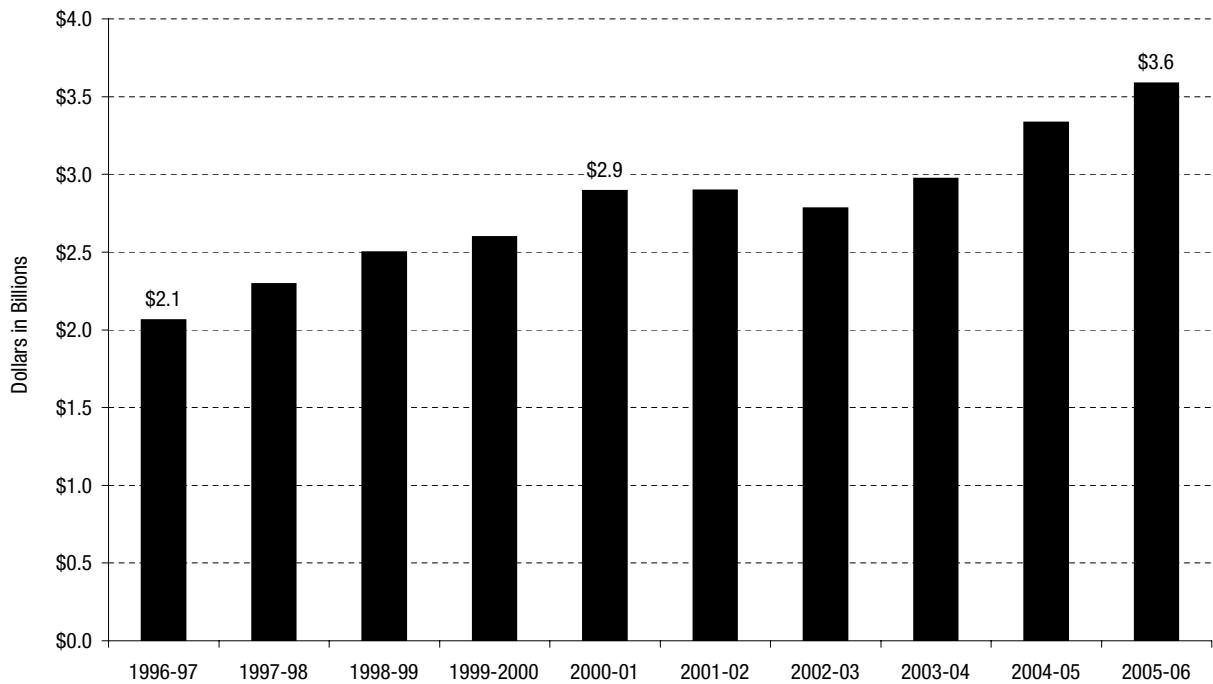
The Governor claims that, compared to other states, “California’s lottery is an underperformer.”<sup>4</sup> The Governor’s May Revision to the 2007-08 Proposed Budget indicates that California’s per capita lottery sales are roughly half of the national average and compare even less favorably when measured against the 10 most populous states.<sup>5</sup> However, California’s 2005-06 per capita lottery sales were greater than those of 13 of the 18 states with lotteries west of the Mississippi River, all of which have per capita sales below the national average (Figure 1).<sup>6</sup> The Governor further claims that, in addition to California’s “dismal national ranking, California lottery sales have been flat.”<sup>7</sup> However, lottery revenues increased from \$2.1 billion in 1996-97 to \$3.6 billion in 2005-06, a 33.2 percent increase, after adjusting for inflation (Figure 2).<sup>8</sup>

Figure 1: Lottery Sales Per Person for States West of the Mississippi, 2005-06



Note: Excludes video lottery terminal sales.  
 Source: CBP analysis of *La Fleur's 2007 World Lottery Almanac* data

Figure 2: California Lottery Revenues, 1996-97 to 2005-06



Source: California Lottery

## Maximizing Lottery Revenues: Who Will Buy the Tickets?

The Governor's May Revision to the 2007-08 Proposed Budget noted that the lottery "has never fulfilled its promise to provide a growing source of revenues to education."<sup>9</sup> The Governor argues that the state should "team up with the private sector to maximize our resources without putting a burden on taxpayers so we can pay our debts, refurbish our infrastructure and make smart investments that secure California's future."<sup>10</sup>

However, research suggests that proposals to boost lottery sales are likely to disproportionately impact lower income and non-white Californians. One national study finds that individuals with lower incomes spend more on lottery tickets per capita than those with higher incomes.<sup>11</sup> Other studies conclude that lottery sales are higher for individuals who have little or no formal education, are residents of urban areas, are between the ages of 45 and 65, and are not white.<sup>12</sup>

By definition, increasing lottery revenues requires boosting the amount Californians spend to purchase lottery tickets. While some argue that individuals can choose whether or not to buy lottery tickets, others argue that it would be inappropriate for the state to pursue a budget-balancing strategy that implicitly transfers a larger share of the cost of public services to those who are least able to afford to pay.

## Increased Lottery Sales May Mean Lower Sales Tax Revenues

Privatizing the lottery could lead to additional lottery sales, but increased lottery sales would likely lead to a reduction in state sales tax revenues and other revenues attributable to consumer purchases, such as fuel, tobacco, and alcoholic beverage taxes. Research suggests that the money Californians spend on lottery tickets may result in a reduction in what they spend on other goods, including goods subject to the state's sales tax.<sup>13</sup> To the extent lottery ticket buyers spend less on taxable goods, the lottery would reduce state sales tax revenues and thus the funds available for public education and other services.

## Does California Need to Privatize the Lottery to Maximize Sales?

While some question whether public policies should encourage gambling as a means to balance the budget, others suggest California could increase lottery sales without privatizing the lottery. One way to boost lottery sales would be to make it easier for people to purchase lottery tickets. Proponents of lottery

privatization note that California has fewer retail lottery locations per person than all but two of the states with lotteries.<sup>14</sup> They argue that increasing the number of retail lottery locations would improve sales. The California lottery could potentially increase sales without privatization by seeking additional vendors of lottery tickets.

Another way to increase lottery sales would be to sell tickets through video lottery terminals (VLTs) or on the Internet. VLTs, which are played like slot machines, produce revenues much greater than traditional lottery games in five of the six states that offer VLTs.<sup>15</sup> The California lottery does not use VLTs and it is unclear whether California law would allow their use. Currently, California does not sell lottery tickets on the Internet. California could explore the use of new gaming technologies or more aggressive marketing without leasing the lottery to a private contractor.

Increasing prize payouts also could increase lottery sales. The California lottery increased prizes for its Scratchers game in 1996-97.<sup>16</sup> Between 1997-98 and 1999-00, revenues attributable to the Scratchers game increased by 75.5 percent.<sup>17</sup> The California lottery argued in 1999 that, "future growth in sales and in money for education will be possible only if the Lottery Act is changed to allow additional sources of prize funds."<sup>18</sup> To date, the Legislature has rejected proposals to boost the share of ticket sales paid as prizes.

## Policy Considerations

The proposal to privatize the California lottery raises a number of important policy questions:

- **Would public schools benefit from increased lottery revenues and by how much?** The Governor states that leasing the lottery would result in California's schools receiving no less than the amount they received in the highest year of lottery funding. In the absence of a specific proposal, it is unclear how the Governor's promise would be achieved. Budget documents suggest that, under the Governor's proposal, schools might receive a guaranteed dollar level of funding rather than the current percentage of sales. However, under current law, education would receive an increase in funding if lottery revenues were to increase. Thus, if sales were to rise, as proponents of privatization suggest they could, schools should receive a commensurate increase in funds, rather than simply the same dollar amount as they currently receive. Moreover, the allocation of lottery proceeds between prizes, education, and operational costs was specified in the ballot measure that originally authorized the lottery. Thus, a reduction in the percentage share of proceeds devoted to education would likely require voter approval.

- **How much might the state receive for privatizing the lottery?** The Governor states that the value of the lottery could be as high as \$37 billion, yet documents prepared by investment bankers advocating for privatization state that a lease could produce proceeds in the range of \$13 billion to \$18 billion.<sup>19</sup> Policymakers would have to balance the importance of regulating lottery marketing and potential changes to revenue allocation formulas with how much money the state could receive from a lottery lease. Private investors would likely pay more for a lottery lease that contains fewer restrictions and allows for increased sales of lottery products. Furthermore, privatization under the terms of a long-term lease would transfer accountability and control over many aspects of the operation of the lottery from a publicly-accountable agency to a private business enterprise.
- **What changes might a private contractor wish to implement in order to maximize lottery sales and how would those changes interact with tribal gaming compacts and existing law?** Potential investors are likely to pay more for a lottery lease if they believe they will be able to increase lottery sales. In order to boost lottery sales, a private contractor may wish to expand the types of lottery games offered. Some suggest that strategies for boosting lottery sales, including some new gaming technologies, could conflict with existing and pending gaming compacts between the state and Native American tribal governments. Those conflicts could reduce the price investors are willing to pay for the lottery. Conflicts also could result in litigation or require the state to renegotiate existing gaming compacts. Any uncertainty would likely reduce the amount investors would be willing to pay for a long-term lease. Investors may also want

to increase lottery sales by offering lottery tickets online or through video lottery terminals. However, that could require changing existing law.

- **How would lottery privatization affect low-income Californians?** Since low-income Californians disproportionately purchase lottery tickets, any attempt to boost lottery sales to generate revenues for the state would implicitly increase the amount low-income Californians pay for public services. Low-income Californians already spend a larger share of their income on state and local taxes than do higher income households.<sup>20</sup> Lawmakers should carefully consider whether it is appropriate public policy to ask those who already pay the largest share of their incomes for public services, and who struggle to make ends meet, to pay more in order to help balance the state's budget.

## Conclusion

The Governor claims that a private contractor may pay billions of dollars for a long-term lottery lease. If the lottery were to be privatized, a private contractor would likely encourage low-income Californians to spend more of their limited dollars on the lottery. Furthermore, increased lottery sales would likely reduce state sales and/or other consumption-based tax revenues. While the Governor promises that a long-term lottery lease would maintain education funding at present levels, it is unclear whether potential increases in lottery revenues would result in increases in education funding. Policymakers will need to analyze any proposed privatization plan to determine if potential benefits outweigh potential costs.

*Jonathan Kaplan prepared this Budget Brief with assistance from Jean Ross. The California Budget Project (CBP) was founded in 1994 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low- and middle-income Californians. General operating support for the CBP is provided by foundation grants, individual donations, and subscriptions. Please visit the CBP's website at [www.cbp.org](http://www.cbp.org).*

## ENDNOTES

- <sup>1</sup> Arnold Schwarzenegger, "Lease the lottery? The case is clear," *Sacramento Bee* (May 18, 2007), downloaded from <http://www.sacbee.com/110/story/184490.html> on May 30, 2007.
- <sup>2</sup> Department of Finance, *Governor's Budget May Revision 2007-08*, p. 91.
- <sup>3</sup> CBP analysis of data included in Department of Finance, *Governor's Budget 2007-08*, p. LJE 163, downloaded from <http://www.ebudget.ca.gov/pdf/GovernorsBudget/0010.pdf> on January 23, 2007.
- <sup>4</sup> Department of Finance, *Governor's Budget May Revision 2007-08*, p. 90.
- <sup>5</sup> Department of Finance, *Governor's Budget May Revision 2007-08*, p. 90.
- <sup>6</sup> CBP analysis of data included in Teresa E. La Fleur, ed., *La Fleur's 2007 World Lottery Almanac*, 15th ed. (April 2, 2007), p. 19.
- <sup>7</sup> Arnold Schwarzenegger, "Lease the lottery? The case is clear," *Sacramento Bee* (May 18, 2007), downloaded from <http://www.sacbee.com/110/story/184490.html> on May 30, 2007.
- <sup>8</sup> CBP analysis of California lottery data. While lottery revenues have increased over the past decade, lottery funds have declined as a share of overall K-12 spending since the lottery's inception. See California Budget Project, *The California Lottery: A Small and Declining Share of School Funding* (March 2007).
- <sup>9</sup> Department of Finance, *Governor's Budget May Revision 2007-08*, p. 4.
- <sup>10</sup> Arnold Schwarzenegger, "Lease the lottery? The case is clear," *Sacramento Bee* (May 18, 2007), downloaded from <http://www.sacbee.com/110/story/184490.html> on May 30, 2007.
- <sup>11</sup> Charles T. Clotfelter, et al., *State Lotteries at the Turn of the Century: Report to the National Gambling Impact Study Commission* (June 1, 1999), p. 13.
- <sup>12</sup> Thomas A. Garrett and Russell S. Sobel, *State Lottery Revenue: The Importance of Game Characteristics* (Federal Reserve Bank of St. Louis: 2002), pp. 1-2.
- <sup>13</sup> Charlene Wear Simmons, Ph.D., *Gambling in the Golden State 1998 Forward* (California Research Bureau: May 2006), p. 92.
- <sup>14</sup> Goldman Sachs documents.
- <sup>15</sup> Teresa E. La Fleur, ed., *La Fleur's 2007 World Lottery Almanac*, 15th ed. (April 2, 2007), p. 19.
- <sup>16</sup> California Lottery, *California Lottery Report to the Public 1999 Annual Report*, p. 4.
- <sup>17</sup> California Lottery, *Lottery Bulletin 2000-3 Higher-Payout Scratchers: The First Three Years* (October 2000), Table A.
- <sup>18</sup> California Lottery, *Lottery Bulletin 1999-1 Higher Payout Scratchers Product Improvement Means More Money for Schools*, p. 1.
- <sup>19</sup> Goldman Sachs documents.
- <sup>20</sup> See California Budget Project, *Who Pays Taxes in California?* (April 2007).