

BACKGROUND PAPER

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Lotteries and State Fiscal Policy

By

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Executive Summary

Forty states and the District of Columbia currently run lotteries and other states are considering them. State-run lotteries are the most popular form of commercial gambling in the U.S., with half or more Americans participating in any recent year. Compared to other forms of legal gambling, they are second only to casinos in terms of the takeout (consumer spending minus prizes). In Fiscal Year 2003, total consumer spending on lotteries was nearly \$45 billion and per capita spending was \$155.33. In FY 2002, the average American spent more money on lotteries than on reading materials or movies (theater admissions only). Approximately 31 percent of consumer spending on lotteries, or almost \$14 billion, was transferred to state coffers in FY 2003, and in FY 2002 lottery funds accounted for 2.2 percent of own-source general revenue in the average lottery state.

The popularity and revenue raising potential of state lotteries raise serious tax policy concerns. First, we must ask whether the lottery is a tax. Although no government agency technically considers it a tax, it is nonetheless an implicit tax. From a revenue standpoint, lottery tickets are no different from other goods subject to excise taxes; once the funds are transferred to state coffers, they can be used in any way the legislature sees fit (even in states that “earmark” lottery proceeds). It does

not make sense to consider the lottery tax to be a user fee, since the revenue raised is not used simply to cover the costs of lottery provision. Operating costs (including vendor commissions) in Fiscal Year 2003 accounted for only 27 percent of the takeout from traditional (not including video lottery terminals) lottery games; the rest was kept by state governments as “profit”—really tax revenue—and used to fund projects that were, for the most part, entirely unrelated to lotteries.

The fact that playing the lottery is voluntary does not make this “profit” any less of a tax, as some lottery proponents have argued. A mandatory tax on a voluntary purchase is still a tax. In this respect, an analogy can be drawn between the sale of state lottery tickets and the sale of alcohol in Alcoholic Beverage Control states, where the government, rather than private vendors, sells alcohol and raises revenue from the operation of liquor stores as well as from excise taxes on alcohol. With both products the government legalized a previously illegal product, granted itself a monopoly on the sale of that product and collects revenue from the sale of the product. In both cases the revenue collected is above and beyond the amount needed to cover the cost of selling the product.

The second tax policy concern is the lack of transparency. Sound tax policy requires taxes that are transparent, or clear to taxpayers. Taxpayers should understand what

is being taxed and at what rate. The implicit nature of the lottery tax makes transparency impossible. Even a taxpayer who understands that a large portion of the ticket price will be kept by the state probably does not know the percentage.

The third concern raised by the lottery is the fact that, as a tax, it is not economically neutral. A neutral tax system would not encourage the consumption of one good over another, thereby distorting consumer spending. Lotteries are singled out for a higher tax rate than other forms of gambling are, which lowers the payout rate (the amount of money gamblers win as a percentage of the money they bet).

Fourth, numerous studies have shown the lot-

tery to be a regressive form of taxation, meaning the poor bear a disproportionately heavy share of the tax burden. The National Gambling Impact Study Commission found that in 1997, although people at all points on the income spectrum played the lottery, players with household incomes under \$10,000 spent almost three times as much money on lotteries as those with incomes over \$50,000.¹

Finally, it does not appear that “earmarked” lottery funds are always used for the alleged purposes. The majority of lottery states earmark their lottery “profits” for public education, but legislators are able to shuffle other funds so that lottery tax revenue supplants, rather than supplements, existing funds for education.

¹ National Gambling Impact Study Commission Final Report, Executive Summary (Washington, DC: Government Printing Office, 1999), 14.

Figure 1 History of Lotteries

- 100 BC Hun Dynasty in China creates keno, uses funds to build Great Wall of China.
- 1567 Queen Elizabeth I establishes first English state lottery.

FIRST WAVE OF LEGAL GAMBLING IN U.S.

- 1612 King James I of England creates a lottery in London to aid England's Jamestown, Virginia settlement.
- 1776 Lotteries are authorized to raise money for the Colonial Army.
- 1792-1842 Continental Congress approves series of lotteries to benefit Washington, D.C.; lottery managers abscond with proceeds.
- 1833-1862 States start banning lotteries due to scandal and fraud; illegal lotteries proliferate.

SECOND WAVE OF LEGAL GAMBLING IN U.S.

- 1860s-1890s The Gold Rush and Reconstruction lead to creation of lotteries in a few southern and western states.
- 1868 Louisiana legislators accept bribes to grant the Louisiana Lottery Company an exclusive 25-year charter.
- 1890 Congress bans all lottery materials from the mail.
- 1895 Congress bans all lottery materials from interstate commerce, effectively ending the Louisiana Lottery.
- 1903 The Supreme Court decides *Champion v. Ames* (the “Lottery Case”), endorsing Congress’ use of the Commerce Clause to prevent the sale of lottery tickets across state lines.

1894-1964: LOTTERY PROHIBITION

- 1930 Americans participate illegally in the popular Irish Sweepstakes.

THIRD WAVE OF LEGAL GAMBLING IN U.S.

- 1931 Nevada re-legalizes casinos.
- 1964 First legal lottery of 20th century starts in New Hampshire.
- 1967 New Jersey lottery starts.
- 1970 New York lottery starts.
- 1975 Federal law is amended to allow lottery ads on radio and TV.
- 1976 Delaware state lottery begins taking bets on National Football League games; NFL sues and loses.
- 1985 The state lotteries of Maine, New Hampshire and Vermont are linked in Tri-State Lotto, the first multi-state lottery.
- 1988 Oregon, Iowa, Kansas, Rhode Island, West Virginia and the District of Columbia create “Lotto America” and form the Multi-State Lottery Association.
- 1989 South Dakota is the first state to approve video lottery terminals.
- 1996 National Gambling Impact Study Commission is created by President Clinton, releases its final report in 1999, calling for a moratorium on the expansion of gambling.
- 2002 Tennessee voters approve referendum for the formation of a state lottery; North Dakotans, who do not have a state lottery, vote to join a multi-state game.
- 2004 North Dakota begins selling Powerball tickets in March; Tennessee lottery starts in January.

Source: North American Association of State and Provincial Lotteries, “Lottery History”; I Nelson Rose, “Gambling and the Law: Pivotal Dates,” 1999

For all these reasons, the lottery is an example of poor tax policy. Most non-lottery states are currently considering or have recently considered starting lotteries, which would be ill-advised from a tax policy standpoint. State-run lotteries make state tax systems more regressive, less transparent, and less economically neutral. Legislators seeking to increase tax revenue would do well to consider other sources.

History of Lotteries

Lotteries are not a recent phenomenon. Americans have participated in them for nearly 400 years.

COLONIAL PERIOD

Henry Fielding wrote the above verse in 1732, as part of his farce *The Lottery*, but he could well have been talking about the American state lotteries of the 21st century.² His contemporaries did not purchase computer-generated lotto tickets from 24-hour convenience stores, nor did they watch Powerball drawings on TV or check the winning lottery numbers on the internet. However, despite more than two centuries of increasing complexity and growth in government and technology, the basic public policy issues inherent in lottery finance have remained much the same since Fielding's day. Is the lottery an appropriate activity for state governments? Is it a form of taxation? If so, is it a regressive tax, borne disproportionately by the poor? Is a lottery an efficient way for a state government to raise a substantial amount of revenue? These and other concerns have been raised since the inception of government-run lotteries nearly four centuries ago.

The above verse notwithstanding, lotteries have enjoyed considerable, widespread public support for much of our country's history. Despite two periods of prohibition and some vocal opposition to legal gambling in general and state lotteries in particular, Americans, for the most part, have not lost their enthusiasm for lotteries—whether state-sponsored, private or illegal. Government, on the other hand, has not been as consistent. The history of state-authorized lotteries in America is an almost 400-year roller coaster ride that has veered several times between outright prohibition and enthusiastic promotion. (See Figure 1.)

*A Lottery is a Taxation,
Upon all the Fools in Creation;
And Heav'n be prais'd,
It is easily rais'd,
Credulity's always in Fashion;
For, Folly's a Fund,
Will never lose Ground;
While Fools are so rife in the Nation.*
—Henry Fielding, 1732

Lotteries are not a uniquely American phenomenon. The World Lottery Association currently has members from over 70 countries on every inhabited continent and lotteries are legal in over 100 countries, with total worldwide sales of \$154 billion in 2003.³ All Canadian provinces currently sponsor lotteries. Nor are lotteries a new phenomenon (see Figure 1). They have flourished in Europe since the 1400s. The oldest lottery still in existence was established in the Netherlands in 1726. Lottery proceeds were used to help build the Great Wall of China and various European public works projects, including the British Museum. In 1567 Queen Elizabeth I established the first English state lottery with prizes that included cash and tapestry.

It was, in fact, the British who brought the lottery tradition to America. In 1612 King James I of England, by royal decree, created a lottery in London. The proceeds were used to aid Jamestown, the first British colony in America. The Virginia Company of London, the financier, raised funds through the use of lotteries that were sophisticated for the times and even had instant winners. The Crown eventually banned these lotteries because they were thought to be robbing England of money. These early lotteries ushered in the beginning of what has been called the first wave of legalized gambling in America. Gambling law scholar I. Nelson Rose has chronicled three waves of gambling in the U.S., which provide a useful framework for studying the history of state lotteries. The first wave extended from colonial times until the early 19th century; the second wave covered a 30-year period after the Civil War; and the third wave began with the Great Depression and continues today.⁴

² Henry Fielding, *The Lottery* (London: J. Watts, 1732), Scene 1, quoted in Charles T. Clotfelter and Philip J. Cook, *Selling Hope: State Lotteries in America* (Cambridge, MA: Harvard University Press, 1989), 215.

³ Patricia A. McQueen, "Super Sales: Weak U.S. Dollar Lifts Global Lottery Sales to New Heights," *International Gaming and Wagering Business* 25 (June 2004): 1.

⁴ I. Nelson Rose, "The Rise and Fall of the Third Wave: Gambling Will Be Outlawed in Forty Years," in William R. Eadington and Judy A. Cornelius, eds., *Gambling and Public Policy: International Perspectives* (Reno, NV: Institute for the Study of Gambling and Commercial Gaming, University of Nevada, 1991), 7.

The first wave involved both public lotteries, which were held by all colonies, and private lotteries, which were not discouraged. The colonies, for the most part, had fairly permissive attitudes toward gambling in general. Even churches benefited from lottery proceeds (Anglican churches held two winning tickets for the first drawing of the Virginia Company lotteries). One researcher has speculated that the popularity of gambling in colonial America was related to the frontier spirit, which involves a certain amount of risk taking.⁵ The amount of gambling varied from colony to colony. Some banned it altogether at first, while others saw it as a harmless diversion.

In all colonies, the lottery came to be seen as more of a civic responsibility than a form of entertainment or gambling.⁶ Proceeds were used for various public works projects, such as bridges, libraries, roads and lighthouses. The line between public and private was sometimes blurred and lottery proceeds also benefited churches and private universities, such as Yale, Princeton and Harvard. Altogether, there were over 160 colonial lotteries before the start of the Revolutionary War.⁷ The war itself, however, turned out to be the largest and most important endeavor funded with lottery proceeds. Lotteries played two roles in the war, as both a grievance leading up to the war and a partial source of funding. Although the English had used lotteries as a way of financing their settlements in America, they began to view gambling in the colonies as evidence of idleness. The colonists protested the Crown's rules for holding lotteries, and in 1769 England attempted to prevent the colonists from holding any lotteries without permission. Once the war started, lotteries were used to help finance it.

After the war, the colonists continued to organize lotteries, which were seen as a more palatable revenue raiser than explicit taxes. In fact, some people did see the lottery as a type of tax. In an 1892 report on the history of American lotteries, A.R. Spofford, Librarian of Congress, claimed that the lottery was "not regarded at all as a kind of gam-

bling; the most reputable citizens were engaged in these lotteries... It was looked upon as a kind of voluntary tax...."⁸ Lotteries were organized and run by "public-spirited citizens who volunteered their services."⁹ There was not much organized opposition. A few religious groups expressed disapproval, but many others happily accepted funding from lottery proceeds.

Adding to the appeal of lotteries was the shortage of other sources of public funding. Taxes were unpopular and, prior to 1790, there were only three incorporated banks. Lotteries therefore helped fill a void and were used for both public and private financing. Most colonial lotteries returned approximately 85 percent of sales in the form of prizes. Tickets were generally sold without commission, which meant the remaining 15 percent went to the beneficiary.¹⁰

19TH CENTURY LOTTERIES

Lotteries were especially popular during the period following the adoption of the Constitution and prior to the establishment of effective local taxation. From 1790–1860, 24 of the 33 states used lotteries to finance jails, courthouses, hospitals, orphanages, libraries and schools, as well as numerous quasi-public projects such as colleges and churches. In the 19th century, due to the expansion in population and industry and the growth of cities, there was an increased need for construction and equipment, schools, roads and canals. While townships and institutions were sometimes granted permission to hold lotteries, government-run lotteries were mainly the province of the states, with two dismal exceptions: a \$10 million lottery approved by the Continental Congress to help fund the American Revolution (the lottery was abandoned when the tickets were not all sold) and a series of lotteries passed by Congress between 1792 and 1842 to improve roads and infrastructure in Washington, DC. Tickets sold well, but the agents conducting the lottery absconded with the proceeds.

⁵ John M. Findlay, *People of Chance* (New York, NY: Oxford University Press, 1986), 4, quoted in Roger Dunstan, "Gambling in California" (California State Library Research Bureau, 1997), ch. 2, p. 2.

⁶ Clotfelter and Cook, *Selling Hope*, 20.

⁷ 164 lotteries are mentioned in John Samuel Ezell, *Fortune's Merry Wheel: The Lottery in America* (Cambridge, MA: Harvard University Press, 1960), quoted in Louis Jordan, "Colonial Currency," Robert H. Gore, Jr. Numismatic Endowment, University of Notre Dame (<http://www.coins.nd.edu/Colcurrency>), and Jordan notes that more have been discovered since 1960.

⁸ A. R. Spofford, "Lotteries in American History," *Annual Report of the American Historical Association*, 1892 (Washington, DC: Government Printing Office, 1893), 174-175, quoted in Clotfelter and Cook, *Selling Hope*, 35.

⁹ R. Clay Sprawls, "A Historical Analysis of Lottery Terms," *Canadian Journal of Economics and Political Science* 20 (August 1954): 354, quoted in Clotfelter and Cook, *Selling Hope*, 34.

¹⁰ National Institute of Law Enforcement and Criminal Justice, "The Development of the Law of Gambling, 1776-1976," (November 1977), quoted in Clotfelter and Cook, *Selling Hope*, 34-35.

The 19th century ushered in an extremely lucrative era in lottery history. One estimate of sales in 1832 indicates they accounted for over 3 percent of national income.¹¹ Of course, estimates based on 150-year old data are somewhat unreliable. In Fiscal Year 2003, lottery expenditures amounted to one half of one percent—only one-sixth of the 1832 estimate (the two figures are not strictly comparable, however). Whatever the exact figure for 1832 may be, it is clear that 19th-century Americans strongly supported and participated in lotteries.

One reason for the high level of participation is that games became easier and more enjoyable due to design changes. The earliest colonial drawings often took days or weeks, and it often took months to sell all the tickets. If the tickets were not all sold, refunds were issued. The slowness and tedium of this process may have contributed to the widely held perception that playing the lottery was not actually gambling. The 19th century also saw a proliferation of shops that sold only lottery tickets; in 1831 in Philadelphia alone, there were 177 lottery shops.¹²

Despite their rapid geographical and financial growth, state-authorized lotteries were not without problems. They were often run by private firms specializing in management and marketing, and as private firms gradually took over more and more of the logistics, fraud became rampant. Ticket brokers received commissions, and lottery ticket sales became a thriving, although not always honest, business. (One positive aspect of this booming business was that some of the brokerage houses, due to their expertise with the numerous currencies in circulation at the time, gave rise to early commercial banks.) Financial agreements between municipalities, legislatures, managers and vendors created controversy and the lottery business became decentralized. In 1811 Pennsylvania authorized a lottery to raise money for the construction of the Union Canal, but only \$30,000 of the estimated \$6,600,000 collected by managers each year was turned over to the Union Canal Company. Many lotteries awarded fewer prizes than advertised or none at all. Governments found themselves unable to regulate the industry and as a result began to consider prohibition.

Gradually, opposition from religious groups and social reformers grew louder and all forms of gambling became part of the whole social reform movement underway, which included abolition

of slavery and promotion of women's rights and temperance. People began to see gambling in general and lotteries in particular as a way of taking advantage of the poor. States started banning lotteries, first in the Northeast with Pennsylvania, New York and Massachusetts in 1833, then in the South and West. By 1862 only two remained: Missouri and Kentucky. Lottery prohibitions were written into state constitutions. The remaining lotteries sold tickets by mail and illegal lotteries soon sprang up.

The short-lived second wave of legal gambling began after the Civil War. The Gold Rush brought miners, professional gamblers and lavish casinos to the West. Meanwhile, the South needed funds to rebuild after the war, and lottery revenue raised for Reconstruction was seen as a voluntary tax.¹³ In 1868 Louisiana legislators accepted bribes in exchange for granting the Louisiana Lottery Company a 25-year charter as the sole proprietor of the state lottery. The company was financially successful, with 90 percent of revenue coming from residents of other states. In 1878 Louisiana had the only legal—albeit scandal ridden—lottery in the country. It finally came to an end after Congress enacted a prohibition against interstate commerce involving lottery tickets in 1890 and a prohibition against all mail related to lotteries in 1895. In 1903 the Supreme Court upheld these prohibitions in the “lottery case” (*Champion v. Ames*). By 1894 there were no legal state lotteries and 35 states had constitutional prohibitions against them. By 1910, with the exception of a few states that allowed horse racing, all gambling was illegal.

20TH CENTURY LOTTERIES AND THE THIRD WAVE OF LEGAL GAMBLING

There followed a 70-year period of prohibition against lotteries, from 1894 to 1964. However, at no point were they totally forgotten—by the public or by elected officials. In New York, a group of philanthropists founded the National Conference for Legalizing Lotteries to support enactment of state and federal lotteries to fund hospitals and other charitable causes. During the Great Depression there was a flurry of proposals for lotteries at the state and federal level, purportedly to fund unemployment relief, and during World War I, members of Congress introduced lottery bills to help cover the costs of the war, among other things. Public

¹¹ Clotfelter and Cook, *Selling Hope*, 36.

¹² Spofford, 190, quoted in Clotfelter and Cook, *Selling Hope*, 37.

¹³ I. Nelson Rose, “Gambling and the Law: Pivotal Dates,” on <http://www.gamblingandthelaw.com/dates.html> (1999), 1.

Table 1
General Information on State Lotteries,
as of July 2004

Games Offered: L=Lotto; M=Multi-State Lotto; N=Numbers Games; V=Video Lottery Terminals;
I=Instant Games; S=Sports Betting; P=Powerball*; K=Keno

Lottery	Games Offered	Start Date	Method of Approval	Percent of Voters Who Voted in Favor	Revenue Uses (GF=General Fund)	Cumulative Sales Through FY 2002 (\$Millions)	Cumulative Prizes Through FY 2002 (\$Millions)	Cumulative Prizes Through FY 2002 (% of Total Sales)	Cumulative Government Transfers Through FY 2002 (\$Millions)	Cumulative Government Transfers Through FY 2002 (% of Total Sales)
AZ	I, N, L, P	07/1/81	Initiative	51%	Miscellaneous (4)	\$4,420.93	\$2,231.85	50%	\$1,479.37	33%
CA	I, N, L, K	10/3/85	Initiative	58	K-12 Education	37,257.82	18,857.75	51	13,880.12	37
CO	I, L, P	1/24/83	Initiative	60	Parks & Recreation	4,783.18	2,734.88	57	1,301.71	27
CT	L, N, I, P, M	2/15/72	Legislation	n/a	GF	12,754.98	7,049.05	55	4,757.32	37
D.C.	I, N, P, L, K, M	8/22/82	Initiative	est. 66%	D.C. GF	3,355.78	1,667.14	50	1,123.45	33
DE	L, N, I, M, P, V	10/31/75	Legislation	n/a	GF	\$ 4,274.13	\$ 901.17	21%	\$ 1,571.55	37%
FL	I, N, L	1/12/88	Referendum	64	K-12 Ed. & College Scholarships	31,205.27	15,186.14	49	12,159.22	39
GA	I, N, M, L, K	6/29/93	Referendum	52	Education (3)	16,265.55	8,572.74	53	5,291.21	33
ID	I, N, P, M, L	7/19/89	Referendum	51	Pub. Sch. & State Perm. Build. Fund	1,008.92	578.65	57	231.65	23
IL	I, N, M, L	7/30/74	Legislation		K-12 Public Schools	29,773.65	15,137.78	51	11,202.86	38
IN	I, N, P, L	10/13/89	Referendum	62%	Miscellaneous (5)	\$ 7,227.87	\$ 4,094.87	57%	\$ 2,142.45	30%
IA	I, N, L, P, M	8/22/85	Legislation	n/a	GF & Gambling Treatment Program	2,866.60	1,554.99	54	779.25	27
KS	I, N, K, L, M, P	11/12/87	Referendum	64	Economic development; Prisons	2,096.13	1,087.97	52	633.62	30
KY	I, N, P, L, M	4/4/89	Referendum	60	GF	6,526.43	3,889.91	60	1,717.64	26
LA	L, N, M, I, P	9/6/91	Referendum	65	GF	3,553.47	1,782.22	50	1,273.51	36
ME	I, N, L, M, P	6/27/74	Referendum	61%	GF	\$ 2,142.16	\$ 1,180.61	55%	\$ 612.01	29%
MD	I, N, K, M, L	5/15/73	Referendum	80	GF	20,194.14	10,450.84	52	7,598.72	38
MA	I, N, L, M, K	3/22/72	Legislation	n/a	Cities & Towns(8)	45,811.77	27,710.32	60	11,724.54	26
MI	I, N, L, M, K	11/13/72	Referendum	67	K-12 public schools	28,466.19	14,658.14	51	11,109.57	39
MN	I, N, P, L, M	4/17/90	Referendum	57	GF & Environ. Trust Fund	3,940.74	2,334.78	59	934.93	24
MO	I, N, P, K, L	1/20/86	Referendum	70%	K-12 Education	\$ 5,670.93	\$ 3,165.09	59%	\$ 1,808.68	32%
MT	I, P, L, M	6/27/87	Referendum	70	GF	425.42	211.50	50	99.15	23
NE	I, P, M, L	9/11/93	Referendum	63	Miscellaneous (6)	645.08	432.42	67	161.60	25
NH	I, N, P, L, M	3/12/64	Legislation	n/a	K-12 Education	2,443.80	1,315.96	54	789.78	32
NJ	I, N, L, M	12/16/70	Referendum	82	Education & Institutions	29,998.33	15,446.88	51	12,353.38	41
NM	I, N, P, M, L	4/27/96	Legislation	n/a	College Scholarships	\$ 645.20	\$ 348.34	54%	\$ 148.00	23%
NY	I, N, L, M, K, V	6/1/67	Referendum	61	K-12 Education	52,245.84	25,177.85	48	21,004.95	40
ND	P, M	3/25/04	Referendum	64	Problem gambling fund & GF					
OH	I, N, M	8/13/74	Legislation	n/a	Education	33,733.38	18,632.15	55	11,740.69	35
OR	I, N, K, P	4/25/85	Initiative	66	Miscellaneous (9)	10,927.21	5,345.90	49	3,018.93	28
	S, V, L, M									
PA	I, N, L, P, M	3/7/72	Legislation	n/a	Senior Citizens	\$ 32,987.53	\$ 16,659.87	51%	\$ 12,747.66	39%
RI	I, N, K, L, P, V	5/18/74	Referendum	76	Distressed cities & towns, GF	6,855.94	4,429.25	65	1,460.13	21
SC	I, N, L, P, M	1/7/02	Referendum	54	Education	335.49	200.31	n/a	81.15	n/a
SD	I, P, L, M, V	9/30/87	Referendum	60	Miscellaneous (11)	6,142.27	3,932.34	64	977.88	16
TN	I, N, P, L	1/20/04	Referendum	58	Education (7)					
TX	I, N, L, M	5/29/92	Referendum	65%	Foundation School Fund	\$29,548.85	\$16,467.39	56%	\$9,755.73	33%
VT	I, N, L, P	2/14/78	Referendum	66	Education	977.53	574.12	59	279.80	29
VA	I, N, L, M	9/20/88	Referendum	57	Education	11,919.94	6,389.49	54	4,130.19	35
WA	I, N, K, M, L	11/15/82	Legislation	n/a	Education (10)	6,275.31	3,460.37	55	1,923.25	31
WV	I, K, P, N, L, V, M	1/9/86	Referendum	67	Education, Tourism, Sr. Citizens	3,971.90	1,156.49	29	1,282.52	32
WI	I, N, P, L	9/18/88	Referendum	65%	Property Tax Relief	\$ 5,460.32	\$ 3,081.47	56%	\$1,846.50	34%
Total U.S.						\$509,135.99	\$268,088.99	53%	\$177,134.68	35%

(1) VLT net machine income is listed as sales. Total prizes do not include VLT prizes which reduces the lottery's prize payout.

(2) VLT sales are listed as "cash in." Total prizes includes cash VLT prizes ("cash out").

(3) Hope Scholarship program, voluntary pre-kindergarten program, technology/capital outlay.

(4) Mass Transit, General Fund, County Assistance, Economic Development, Heritage Fund, Local Transportation Assistance Fund

(5) Education, License Plate Tax, Police/Fireman pensions, Teachers Retirement, Build Indiana

(6) Education Innovation Fund, the Nebraska Environmental Trust Fund and Compulsive Gamblers Assistance Fund.

(7) Currently goes to scholarships for students attending public or private universities, colleges or technical schools.

(8) Cities and towns are permitted to decide how funds will be used.

(9) Economic Development, State Parks & Salmon Restoration & Education (K-12 public schools).

(10) Student Achievement Fund & School Construction Fund (effective July 1, 2001).

(11) General Fund, Capital Construction Fund, Property Tax Reduction Fund.

Source: Data from La Fleur's 2003 World Lottery Almanac; state lottery agency web sites.

***Note:** Powerball is a multi-state lotto game but is listed separately due to its widespread popularity and the large number of states that participate.

support for these proposals was usually high, with every poll taken after 1938 showing more support than opposition.¹⁴ A Gallup poll taken in 1942 showed that 54 percent of respondents favored a lottery to defray the cost of the war. (As late as the mid-eighties, 65 percent supported a federal lottery.)¹⁵

Meanwhile, illegal lotteries continued to flourish, including “policy,” which was popular in Chicago and initially involved a side bet on a legal lottery. Once lotteries were outlawed, policy operators began drawing their own numbers. The other illegal game, “numbers,” was played in the Northeast, and was often based on the payouts of local racetracks. In 1930 approximately 13 percent of Americans participated in the Irish Sweepstakes by purchasing tickets that had been smuggled into the country illegally.¹⁶

The third wave of legal gambling began in 1931 when Nevada re-legalized casinos and slot machines. After the stock market crash of 1929, legalized gambling was seen as a way to stimulate the economy.¹⁷ However, it was another 35 years before New Hampshire ushered in the modern era of state lotteries. In 1964, after 27 years of annual lottery bills in the state legislature (one passed in 1955 but was vetoed by the governor), New Hampshire introduced a lottery, approved by 76 percent of the voters in a public referendum. New Hampshire sidestepped a federal excise tax on wagering, which the IRS intended to apply to the lottery, by conducting the lottery as a sweepstakes modeled after the Irish Sweepstakes. The winning numbers were tied to the winner of a horse race since horse racing was exempt from the tax.¹⁸ Tickets were sold only at racetracks and state-run liquor stores and drawings were held only twice a year. In the first year of operation 80 percent of tickets were sold to residents of neighboring states.¹⁹

In the years leading up to 1964 there was not only a growing acceptance once again of gambling in general, but also a growing opposition to tax increases. New Hampshire had no sales tax or income tax and relied heavily on property and excise taxes, with over half of the state revenue coming from excise taxes on alcohol, tobacco and horse

racing.²⁰ The lottery was thought to be part of a continued resistance to a state sales tax, and also a way to increase state aid to education, in which New Hampshire ranked lowest in the nation. The state was also facing a budget deficit.

New Hampshire paved the way for New York to establish a lottery in 1967 with 61 percent of the vote and New Jersey in 1970 with 82 percent of the vote (see Table 1). Between 1963 and 1965 legislatures in six other states considered and rejected lottery bills. The lottery was approved in New York despite a considerable amount of opposition in part because the sales tax had recently been increased and legislators were reluctant to increase taxes further. The New Hampshire and New York lotteries were not financially successful, and New Jersey became the first modern lottery to achieve financial success, due to more frequent drawings and larger winnings.

Lotteries spread rapidly across the country, first in the Northeast, and then the West and Midwest, with the South the last holdout (see Figure 2). In many states a referendum or initiative was necessary to remove a constitutional ban on lotteries. Legislators and voters in non-lottery states saw that lottery states were managing to raise revenue efficiently and without corruption, which allayed their fears about bringing the lottery to their own state. In addition, cross-border ticket sales were high and legislators reasoned that if their residents were going to play the lottery, it would be preferable to have the money spent in the state. In the 1980s, private suppliers of lottery equipment began lobbying for the passage of lotteries and conducting petition drives among voters in states where legislators were hesitant or opposed. Convenience stores also had an interest in the adoption of lotteries since the sale of lottery tickets increased their business and they received commissions for the sale of winning tickets. Almost all of the referenda and initiatives passed, although some states approved lotteries through legislation alone (see Table 1). In 1986 North Dakota was the first state to vote against starting a lottery.

In 1985, three states—Maine, New Hampshire and Vermont—joined forces to form the first multi-state lottery, Tri-State Lotto. In 1988, five more states—Oregon, Iowa, Kansas, Rhode Island and

¹⁴ Clotfelter and Cook, *Selling Hope*, 43.

¹⁵ *Ibid.*, 44.

¹⁶ *Ibid.*, 38.

¹⁷ Dunstan, ch. 2, p. 8.

¹⁸ Commission on the Review of the National Policy toward Gambling, *Gambling in America* (Washington, DC: Government Printing Office, 1976), 17-18, quoted in Clotfelter and Cook, *Selling Hope*, 143.

¹⁹ I. Nelson Rose, “The Legalization and Control of Casino Gambling,” *Fordham Urban Law Journal* 8 (1980): 256n, quoted in Clotfelter and Cook, *Selling Hope*, 143.

²⁰ David Weinstein and Lillian Deitch, *The Impact of Legalized Gambling: The Socioeconomic Consequences of Lotteries and Off-Track Betting* (New York: Praeger, 1974), 14-15, quoted in Clotfelter and Cook, *Selling Hope*, 142.

West Virginia—and Washington, D.C. discovered the appeal of large jackpots and created the Multi-State Lottery Association. Later that year they launched Lotto America, now known as Powerball.

Two states started lotteries in the 1960s, 12 in the 1970s, 18 in the 1980s, six in the 1990s and three since 2000. Currently, 40 states and the District of Columbia have lotteries. Tennessee and North Dakota joined the ranks of lottery states quite recently. North Dakotans approved a lottery in 2002 after rejecting it three times at the ballot box (1986, 1988 and 1996). North Dakota is unique in that it does not plan to offer any state games of its own, only multi-state games. In January 2004 the Tennessee Lottery Corp. began selling tickets, with proceeds “earmarked” for college scholarships. With the advent of the Tennessee lottery, Utah and Hawaii are the only two states without any form of legal gambling.

Reasons for Lottery Adoption

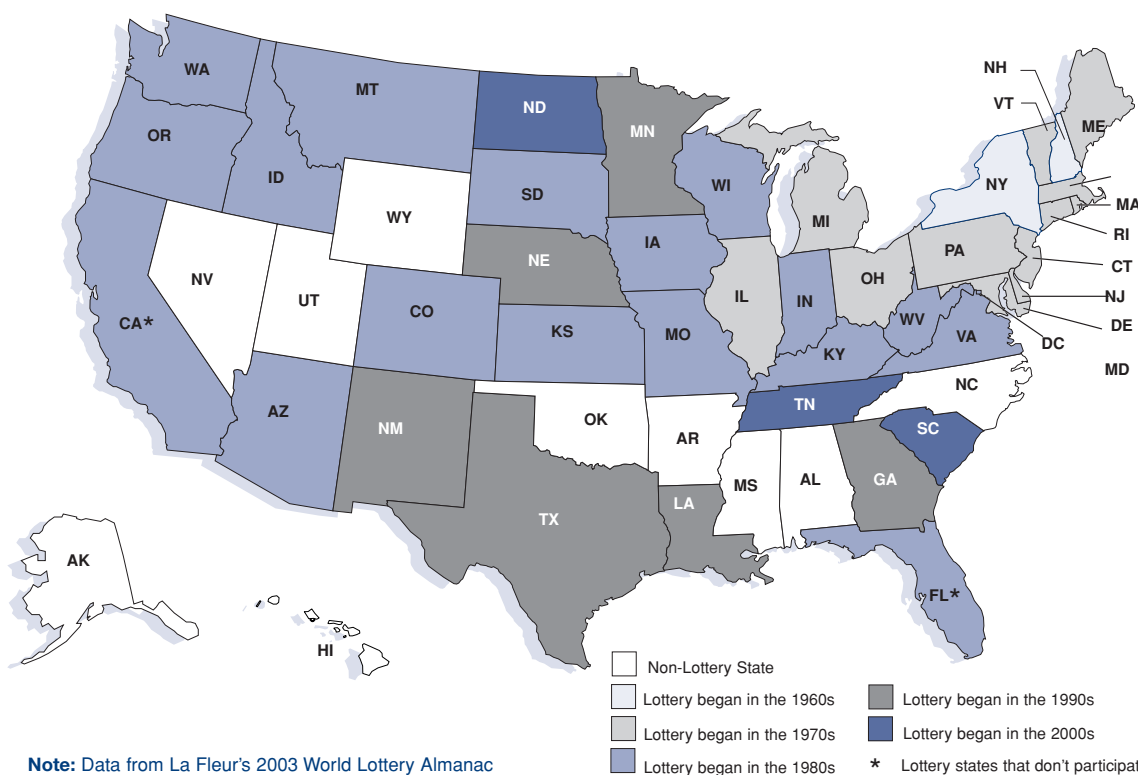
What motivates some states to enact lotteries, even in the face of political and social opposition, while others resist?

RAISING REVENUE

There are several possible reasons states adopt lotteries. The most obvious reason would seem to be the desire to raise revenue in a way that is not unpopular politically, especially in times of fiscal crisis. However, the revenue-raising factor is not as simple as it seems on the surface. Some studies have found that, in general, fiscal crises are not reliable predictors of lottery adoption, especially for states that adopted lotteries in the 1980s and 1990s.²¹ States that adopted lotteries prior to 1980 were probably motivated by fiscal stress more than lottery latecomers were.

For states whose lottery adoptions do appear to be related to fiscal stress, state and local real short-term debt per capita in particular and, to a lesser extent, a decline in income levels have been posited by some researchers as predictors of lottery adoption, although declining tax revenues and declining intergovernmental transfers were not found to be significant factors.²² In general, it is not clear that the main reason states adopt lotteries is fiscal crisis. There are most likely numerous factors that work in tandem.

Figure 2
The Spread of State Lotteries



Note: Data from La Fleur's 2003 World Lottery Almanac

THE INFLUENCE OF NEIGHBORING STATES

One such factor is the influence of neighboring states. A state whose neighbor has a lottery is more likely to enact one itself, due in part to concerns that its citizens are spending money in other states and the pragmatic notion that people are going to gamble anyway, so they may as well spend their money at home. Many legislators view money spent on neighboring states' lotteries as lost revenue. It has been suggested that certain states function as leaders or trendsetters, not just in lottery adoption but in other state innovations as well, and nearby states follow if they like the results.²³ However, studies have shown that non-lottery states do not "lose" a significant amount of money to neighboring states unless there is a population of 25,000 or greater within 50 miles on each side of the shared border.²⁴

Pro-lottery groups pushing for lottery enactment have gone so far as to run advertisements capitalizing on the desire to keep revenue in the state. South Carolinians saw TV ads featuring a convenience store clerk from Georgia thanking their governor for opposing a lottery, so that South Carolinians would continue to spend money on the Georgia lottery and help pay for Georgia students' education. The ads have since moved to the non-lottery state of North Carolina, where the clerk thanks residents of that state for playing the newly formed South Carolina lottery.

THE INFLUENCE OF THE LOTTERY INDUSTRY

Another possible factor in lottery enactment is that as more and more states establish lotteries, the lottery industry—retailers and suppliers—becomes wealthier and amasses more lobbying power. Convenience store owners view the lottery as a way to draw in new customers as well as earn commissions on ticket sales and bonuses for the sale of winning tickets and participation in marketing pro-

grams. There are over 180,000 lottery retailers in the U.S.²⁵—one for every 1,583 Americans and approximately one for every 1,400 residents of lottery states in FY 2003, with the highest concentration (one for every 380 residents) in South Dakota (this figure includes video lottery operators), the second highest in Vermont (one for every 857 residents) and the lowest in Arizona (one for every 2,224 residents), and Washington (one for every 1,898 residents). (See Table 2.) Suppliers of lottery products and services also have an interest in the proliferation of state lotteries and have helped place lottery proposals on ballots, advertised before elections and lobbied elected officials.

CHARACTERISTICS OF LOTTERY STATES

There are some characteristics that lottery states, especially those that adopted lotteries early, share, although these characteristics are not necessarily precipitating factors. A 1989 study showed that the electorate of states that adopted lotteries before 1980 were more liberal in their political views than voters in other states, as measured by their presidential election votes and views on various social and political issues.²⁶ More recent studies have shown that lotteries are more likely to be enacted in states with an initiative or referendum process²⁷ and that states with lotteries are less likely to have balanced budget amendments, Democratic governors or a high percentage of Democratic assemblymen (perhaps because Democrats find other forms of taxation more acceptable).²⁸ It has also been shown that heavily and densely populated states are more likely to enact lotteries, most likely since the potential revenue is greater due to the larger supply of players and larger jackpots with which to lure players.²⁹ One study found that tax and expenditure limits on increases of property assessment are positively linked to the adoption of a lottery.³⁰ The same study showed that states with high per capita incomes were more likely to pass early lotteries.

²¹ See, for example: James Alm, Michael Mickee and Mark Skidmore, "Fiscal Pressure, Tax Competition, and the Introduction of State Lotteries," *National Tax Journal* XLVI (December, 1993): 463-476; Frances Stokes Berry and William D. Berry, "State Lottery Adoptions as Policy Innovations: An Event History Analysis," *American Political Science Review* 84 (June, 1990): 395-415; Mark M. Glickman and Gary D. Painter, "Do Tax and Expenditure Limits Lead to State Lotteries? Evidence from the United States: 1970-1992," working paper (1999); and Clotfelter and Cook, *Selling Hope*, 159.

²² Alm, Mickee and Skidmore, 471.

²³ See, for example: Jack L. Walker, "The Diffusion of Innovations among the American States," *American Political Science Review* 3 (Sept. 1969): 897, quoted in Clotfelter and Cook, *Selling Hope*, 150; and Berry and Berry.

²⁴ Alm, Mickee and Skidmore, 467.

²⁵ Based on data from the North American Association of State and Provincial Lotteries, <http://www.naspl.org/faq.html#purchase>.

²⁶ Clotfelter and Cook, *Selling Hope*, 147.

²⁷ Alm, Mickee and Skidmore, 473.

²⁸ Glickman and Painter, 18.

²⁹ Alm, McKee and Skidmore, 468.

CHARACTERISTICS OF NON-LOTTERY STATES

The states that do not have lotteries are: Alabama, Alaska, Arkansas, Hawaii, Mississippi, Nevada, North Carolina, Oklahoma, Utah and Wyoming. States that have no lotteries tend to have lower per capita incomes, lower state/local tax burdens and earlier Tax Freedom Days (Tax Freedom Day is calculated annually by the Tax Foundation and measures total taxes as a percentage of income). In some of these states, it is easy to pinpoint factors other than the aforementioned characteristics that may partially explain the absence of lotteries. For example, in some non-lottery states, such as Utah, Mississippi and Alabama, there is widespread religious opposition to gambling. In Nevada the casino industry has a vested interest in preventing lotteries and any possible competition they could create.

Alaska and Hawaii's geographic isolation means they do not have to worry about "losing" money to neighboring states' lotteries.

Types of Lottery Products

The lottery encompasses five basic types of games, with numerous variations of each type and new products developed frequently to hold players' interest and attract new players. Different methods of play offer different prizes and odds of winning. The wide array of products offered attests to states' ingenuity and determination to raise as much revenue as possible from the lottery; the state governments function more or less like private companies developing and marketing new brands of soda, clothing or potato chips.

INSTANT GAMES

The early New Hampshire lottery was actually a sweepstakes, with tickets sold only at racetracks. It was a passive game where players simply bought tickets and then waited days or weeks to see whether their tickets would be drawn. Since passive games do not have much "play value," scratch-off instant games were introduced in the early 1970s. They allow players to find out immediately whether they won and often receive their prizes from the store clerk immediately. This instant gratification appeals to players, and retailers like the fact that these games do not require computerized terminals and are therefore easier for small stores to sell. Prizes range from \$1 to over \$100,000.

NUMBERS GAMES

Next came daily numbers games, which let customers select their own three- or four-digit numbers. Players win if their numbers are randomly chosen in the correct order. Numbers games allow players to choose "lucky" numbers, which creates more play value. These games are virtually identical to the illegal numbers games played in many urban areas, and lottery agencies have been accused of taking advantage of the low-income groups who participate in the illegal numbers games.

LOTTO

Probably the most widely known lottery game is lotto. When people talk about "winning the lottery," they are often talking about multi-state lotto games, since these are the games that generate the largest

Table 2
Lottery Retailers, Fiscal Year 2003

State	Number of Residents for Each Retailer	Commissions*	State	Number of Residents for Each Retailer	Commissions*
Arizona	2,224	6.5%	Nebraska	1,445	5%
California	1,855	4.5% – 6%	New Hampshire	996	5%
Colorado	1,636	6% – 7%	New Jersey	1,434	5%
Connecticut	1,233	5%	New Mexico	1,593	6%
D.C.	1,205	5%	New York	1,252	6%
Delaware	1,784	5%	Ohio	1,263	5.5%
Florida	1,454	5%	Oregon	1,073	5% – 10%
Georgia	1,160	5% – 10%	Pennsylvania	1,740	5%
Idaho	1,311	5%	Rhode Island	951	5% – 8%
Illinois	1,547	5%	South Carolina	1,171	7%
Indiana	1,465	5.5% – 7%	South Dakota	380	5%
Iowa	1,225	5% – 5.5%	Texas	1,337	5%
Kansas	1,494	5%	Vermont	857	5.75%
Kentucky	1,362	5%	Virginia	1,490	5%
Louisiana	1,468	5%	Washington	1,898	6% – 7%
Maine	911	5% – 8%	West Virginia	1,097	7%
Maryland	1,522	5%	Wisconsin	1,473	5.5% – 6.25%
Massachusetts	880	5%			
Michigan	1,095	6%	Total U.S.	1,583	
Minnesota	1,547	5.5%			
Missouri	1,116	5%	All Lottery States	1,390	
Montana	1,523	5%			

* These percentages do not include bonuses for the sale of winning tickets, the sale of a specified number of tickets or participation in promotional programs.

Note: Tennessee, which did not have a lottery in FY 2003, currently has a commission of 6.5%; North Dakota, which did not have a lottery in FY 2003, currently has a commission of 5%. (Data from state lotteries' web sites.)

Source: Data from the North American Association of State and Provincial Lotteries; Census Bureau population data; Tax Foundation calculations

jackpots and hence the most attention and widespread excitement. Most states offer their own lotto games as well, but multi-state games such as Powerball are probably better known. Players choose a handful of numbers from a large set—for example, 6 numbers from 1 to 44—and win by picking the correct numbers in any order. In lotto, a portion of the proceeds is paid to players who correctly pick most but not all of the numbers, with the largest prize reserved for the person(s) who correctly picks all of them. If one drawing produces no winner, the money is “rolled over” and another drawing is held. As jackpots grow larger, participation increases and players often travel from other states to purchase tickets.

States with large populations are at an advantage in state lotto since prizes can become quite large, sometimes reaching the hundreds of millions of dollars. The largest individual win to date is \$314.9 million in Powerball. However, the winner received only \$170.5 million. Winners of large prizes must choose one of two payment options: an annuity, which is paid over a period of many years, or a lump sum payment, which is smaller than the actual jackpot.

The excitement generated by large jackpots pulls in more players and more revenue. Powerball and other multi-state lotto games expand each state's player pool and therefore the jackpot, which in turn draws in more players. Therefore, joining a multi-state lottery association benefits states with small populations more than heavily populated states: the increase in the pool of potential customers—and therefore the size of the jackpot—is more dramatic. North Dakota recently became the first state to join a multi-state lottery without first having a game of its own, thereby alleviating the set-up costs of a single-state lottery. Maine, Vermont and New Hampshire offer a Tri-State Lotto game, and 28 states plus the District of Columbia belong to the Multi-State Lottery Association, which offers Powerball, Hot Lotto and other games. In addition, 11 states participate in a lotto game called Mega Millions.

SPORTS BETTING IN LOTTERIES

Oregon is currently the only state that incorporates sports betting into its lottery (some types of sports betting are also legal in Nevada, which does not have a lottery). Delaware tried it first: in 1976 the Delaware State Lottery took bets on National Football League games. The NFL sued the lottery and lost, but the Delaware Sports Lottery was abandoned after just 14 weeks.

KENO

Keno is a game that originated in casinos and requires players to pick several numbers, allowing them to place multiple bets in a short period of time. Frequent drawings notify winners within minutes. Keno has sparked legal battles over its fixed payouts: customers bet against the operator (the state in this case) rather than against each other, which means the operator stands to lose money if players are unusually lucky. Keno was temporarily suspended in California after the state Supreme Court ruled that it violated the state's prohibition against banked games (games where prizes are paid by the operator, rather than from the money bet by other players) and was not technically a lottery game. California has since reformatted and reintroduced the game.

VIDEO LOTTERY TERMINALS

Design and Location of Video Gaming Devices

Keno is not the only game that has led to a legal battle. Video lottery terminals (VLTs) are also a controversial, relatively new lottery innovation, and are so far available in only a handful of states. VLTs are player-operated devices connected to a centralized computer network that offer electronic games of chance such as blackjack, slots and poker. They are played on a video screen and prizes are distributed immediately from the retailer. Generally, states permit them only at racetracks and establishments with liquor licenses. Two states—Montana and Louisiana—permit and regulate video gaming devices (VGDs) that are not technically part of the state lottery, but are otherwise the same as VLTs and sometimes mistakenly referred to as VLTs. Montana's VGDs are located in liquor-license establishments and regulated by the state's Department of Justice. Louisiana's machines are located at racetracks and in hotels and truck stops, and are regulated by the state police. (In addition, Iowa and New Mexico allow traditional slot machines at racetracks and, in New Mexico, non-profit fraternal organizations.)

The VLT trend started when South Dakota introduced video poker lottery terminals in 1989. In 1990, West Virginia installed VLTs at racetracks, after the racetrack industry recognized the potential for new revenue. Gambling parlors at racetracks are often referred to as “racinos.” Some states regard VLTs not only as a way to raise revenue, but also as a way to rejuvenate a sluggish racing industry. In fact, the legislation that estab-

lished the Delaware VLTs was named The Horse Racing Rejuvenation Act. The rationale of locating VLTs and VGDs only at racetracks and liquor-license establishments is that VLTs are more similar to casino-style gambling than traditional lottery games are, and are therefore more suitable for environments where other forms of gambling are already going on, or where minors are not permitted.

Currently, six states—Delaware, Oregon, Rhode Island, West Virginia, New York and South Dakota—offer VLTs, although New York calls its machines “video gaming machines” (VGMs) rather than “video lottery terminals.” New York, Delaware and Rhode Island all have machines located only at pari-mutuel facilities—racetracks in New York and Delaware, and greyhound racing and jai alai facilities in Rhode Island. Oregon has machines at racetracks and liquor license establishments. South Dakota allows the machines only at establishments with liquor licenses. West Virginia has the largest number of venues: racetracks (both horse and greyhound racing), liquor license establishments and fraternal and veterans’ associations.

Recent VLT Additions and Proposals

New York

Several states have recently, amid some legal and political controversy, approved VGDs. Earlier this year, New York added racetrack video gaming machines (VGMs) to its lottery line-up. Lottery officials were careful to distinguish their video slot machines from traditional slot machines, which are technically unconstitutional in New York, although the difference was mainly a technicality. Even after the machines were installed, there was concern that they would be found unconstitutional. In July, a New York appellate court decision held that the machines are lottery games rather than traditional slot machines, and their design is therefore constitutional. However, this was hardly cause for New York racinos to celebrate, since the court also found that the distribution of VGM “profits” was unconstitutional. The problem was that racetracks were allowed to keep a large percentage of the revenue. The court ruled that VGMs must be bound by the revenue distribution requirements that apply to other lottery games, which means all “profits” must be turned over to the state to fund education. The decision is being appealed.

Maryland

Maryland has been engaging in a heated battle over VLT legalization for quite some time and the governor and legislature seem to have reached an impasse. Various House and Senate bills have been considered, including one that would have abolished the state lottery agency and the state racing commission and replaced them with the State Lottery and Horse Racing Agency.

Ohio

Ohio legislators recently voted down a proposed that would have asked voters to approve a constitutional amendment allowing VLTs. It would have appeared on the November ballot. The VLTs supposedly would have helped counteract a shortage in the education budget. However, Ohio educators were not all enthusiastic about the proposal. The Ohio School Boards Association expressed concern that “local voters are likely to perceive that the VLT monies going to education will reduce or eliminate the need for local levies” and “the use of VLTs to fund education is an unstable source of revenue.”³¹

Pennsylvania

In July, Pennsylvania’s governor signed a bill authorizing slot machines at racetracks. They will not actually be part of the lottery, but they merit comment nonetheless due to the political debate surrounding the bill and the purported use of the revenue. The debate over authorization was much the same as the debates in other states over actual VLTs, which demonstrates the blurring of the line between video lottery games and traditional gaming devices. The tax revenue from the machines will allegedly be used to lower local property taxes by providing state funding for education. Pennsylvania will collect a 34 percent gambling tax on 61,000 slot machines. (According to the Pennsylvania Economy League, this equals approximately “1 slot machine per classroom.”)³²

Lack of Uniformity in Administration and Design of VGDs

The addition of VLTs, VGDs and VGMs to state lotteries created a grey area of lottery finance and administration. State laws vary broadly in their definitions of VLTs and distinctions between VLTs and traditional casino gaming machines. Some laws are vague on what constitutes a video lottery terminal. Delaware’s law, for example, seems broad enough to

³¹ Ohio School Boards Association Legislative Report, Vol. 25, No. 25 (May 31, 2004), available at <http://www.osba-ohio.org/53104LR.htm>.

³² The Pennsylvania Economy League, “Property Tax Relief: The Final Analysis,” (July 2004), available at <http://www.issuespa.net/articles/9352/>

include all gaming devices.³³ The nature of these games also raises concerns about gambling addictions: video poker on lottery terminals may be, to players, indistinguishable from some games offered in casinos.³⁴ New York's VGMs are overseen by the state lottery, but players probably don't feel like they are "playing the lottery" when they use VGMs at racetracks.

Compounding the problem is the fact that VGDs are not regulated the same way in every state. They can be administered by the state lottery, or regulated by the state under casino laws or pari-mutual laws. (Pari-mutuels are games where the prize is shared by multiple winners in proportion to the amount they bet. They include horse racing, jai-alai and dog racing.) Louisiana's devices are regulated by the state police, not the lottery, but they are often referred to as VLTs.³⁵ In some states, the operator (the track, bar or retail establishment) owns the machines with the state providing maintenance and oversight, while in others the state owns the machines.

VLTs tend to bring in large amounts of revenue, often surpassing traditional lottery games. Four of the top five states in per capita sales have VLTs. (It should be noted that both Rhode Island and South Dakota report gross VLT sales rather than net sales, which are reported by West Virginia, Oregon and Delaware, so VLT states' revenue data—both total and per capita sales—are not strictly comparable.)

Some gambling experts believe VLTs, due to their revenue-raising potential and differences in administration, are not comparable to other types of lottery games and should be not included in monetary comparisons. VLTs, VGMs and VGDs allow players to bet a comparatively large amount of money more quickly than traditional lottery games, and states that offer them do not have a uniform system for the reporting of revenue, prizes and government transfers. Therefore, data from all VLT states are not strictly comparable, and some reports on lottery revenue do not include VLT data. They are included in calculations in this paper, however, unless otherwise noted, since they are products of state lotteries regardless of their distinguishing characteristics.

Odds of Winning

One of the most controversial aspects of lotteries is the fact that the odds of winning a large prize are quite low, and lottery critics believe state governments are deluding citizens into an imprudent use of their disposable income. It is often said that one has a better change of being struck by lightning than of winning the lottery. One state representative has even proposed requiring a disclaimer to that effect on certain lottery tickets.³⁶ Since the odds of winning vary from game to game, this claim can be evaluated only if one particular game is considered rather than "the lottery." A game that requires a player to choose five numbers from a field of 30 offers better odds than one that draws five out of 40. The lightning claim is mainly rhetoric used by lottery critics. However, since this argument is used so frequently and since it succinctly and, to many people, persuasively encapsulates critics' views that the government is cheating people out of money, it is worth looking into.

A person's chance of being struck by lightning in a given year is about one in 780,000.³⁷ If we assume a person purchases only one lottery ticket per year, we can then compare the odds of winning the top prize in a given lottery game to the odds of a lightning strike over the course of a year. (Of course, if a person plays more frequently, his chances of winning increase.) People who cite the lightning statistic are usually referring to large multi-state lotteries, but a meaningful comparison must include all lottery games. The odds of winning any lottery game can be found on the ticket, obtained from the lottery agency or calculated using the following formula:

$\frac{x!}{y!(x-y)!}$ where x equals the total pool of numbers and y equals the number of numbers a player is required to choose.

Using this formula, we can see that a lotto game that draws six numbers from a field of 44 offers odds of one in 7.1 million. A player is almost ten times as likely to be struck by lightning as to win this lotto game. However, a 5/40 game offers slightly better odds than being struck by lightning: one in 575,757. If you play Louisiana Lotto once a year, you are five times more likely to be struck by lightning in that year than to win the lottery (one in 3.8

³³ Eugene Martin Christiansen, "Central Systems for Machine Gaming: A Good Policy?", Christiansen Capital Advisors, LLC, (Dec. 2003), 4.

³⁴ Ibid, 5.

³⁵ Ibid, 22.

³⁶ Massachusetts State Representative John Locke. See <http://www.lotteryinsider.com/lottery/massach.htm>.

³⁷ Based on data from the National Oceanic and Atmospheric Administration (http://www.wrh.noaa.gov/Glasgow/press/LAW_PRInfo.pdf) and population data from the U.S. Census Bureau.

million with a 6/40 format). In Connecticut and South Dakota, however, a lottery win is nearly twice as likely as a lightning strike for those who play one of the 5/35 games. Powerball, which requires players to choose 5 numbers from a field of 53 followed by one number from a field of 42, offers dismal odds: one in 120,526,770. The probability of winning a simple three-digit (non-lotto) numbers game, however, is much higher: one in a thousand. Another factor to keep in mind is the fact that lotto games reserve a portion of the prize money for those who correctly pick most of the winning numbers, so it is possible to win a large sum of money without actually “winning the lottery.”

Revenue

Lotteries generated an amazing \$45 billion in consumer spending in FY 2003. There are several ways to analyze lottery revenue: as a per capita figure; by type of game; as a percentage of total gambling revenue; and as a breakdown of prizes, operating costs and government transfers.

BREAKDOWN INTO PRIZES, OPERATING COSTS AND TAX REVENUE

Lottery tickets generally cost between 50 cents and \$10, with \$1 being standard. Of every dollar spent on lottery tickets, slightly more than half is returned to the players in the form of prizes. The percentage is lower than in other forms of gambling but has been increasing somewhat and varies from state to state. Of the remainder, part is transferred to the state governments and part is used to cover operating costs, including vendor commissions and advertising. Nationwide, in Fiscal Year 2003, 31.12 percent of revenue—or almost \$14 billion—was transferred to state coffers. (See Table 3.) From the New Hampshire lottery’s inception in 1964 through Fiscal Year 2002, lotteries generated cumulative sales of \$509,135,990,000. (See Table 1.) Of this amount, 53 percent was paid out in prizes and 35 percent went into government coffers. The remaining 12 percent covered administrative costs and commissions to retailers.

The breakdown of prizes, administrative costs and government transfers varies considerably from state to state. (See Table 3.) In Fiscal Year 2003, as a percentage of total sales, Oregon transferred the most revenue to the state government (45.4 per-

cent), followed by West Virginia (38 percent) and Pennsylvania (36.9 percent). Meanwhile, South Dakota transferred the least—only 17.3 percent. Rhode Island had the second lowest percentage (18.7 percent) and Vermont was third from the bottom (20.4 percent). It should be noted that Rhode Island, West Virginia, South Dakota and Oregon all have VLT income and, due to differences in reporting methods, these figures may not be strictly comparable to other states’ figures. These transfers to state governments are generally called “profits” by the states, but, as will be discussed later, they are actually tax revenue.

When VLTs are taken out of the equation (see Table 4), Pennsylvania reported the largest profit as a percentage of sales (36.9 percent), followed by New Jersey (36.3 percent) and Florida (35.7 percent). The three lowest percentages were found in Oregon (17.6 percent), Vermont (19.8 percent) and Washington (21.0 percent). With regard to operating expenses (also excluding VLTs), Massachusetts was the most efficient (7.3 percent of sales), followed by New Jersey (9.1 percent) and Connecticut (9.6 percent). Montana spent the highest percentage on operating costs (27.9 percent), followed by Nebraska (22.8 percent) and South Dakota (22.4 percent). It should be noted that states with larger populations and/or higher sales should be expected to have lower operating costs due to economies of scale. Some states place a cap on administrative costs.

In Fiscal Year 2003, not including VLT income, Massachusetts gave customers the best deal, returning 71.8 percent of each dollar as prizes. Oregon was next (70.1 percent), followed by Vermont (64.7 percent). Louisiana was the lowest (50.1 percent), just below Montana (50.6 percent) and Delaware (51.5 percent).

CONSUMER SPENDING AND PARTICIPATION

The majority of Americans have overcome any reservations they may have had about state lotteries. They not only play the lottery; they also spend large sums of money.

Lotteries Compared to Other Types of Gambling

In 2003, 88 percent of the U.S. population lived in states that offered lotteries and many others played

³⁸ See, for example: GTech Corporation, “The Vital Signs of Legalized Gaming in America: GTech’s 8th Annual National Gaming Survey,” (2000), 5; The Gallup Organization, “Gambling in America” (1999), quoted on North American Association of State and Provincial Lotteries web site, <http://www.naspl.org/faq.html>; American Gaming Association, “State of the States: The AGA Survey of Casino Entertainment” (2003); National Opinion Research Center, “Gambling Impact and Behavior Study: Report to the National Gambling Impact Study Commission,” (1999), 7.

in neighboring states. While estimates vary as to how many Americans play the lottery, polls generally show that half or more have played in any recent year, which makes lotteries the most popular form of commercial gambling.³⁸ In 2002 lotteries accounted for 27.1 percent of the takeout (consumer spending minus prizes, also sometimes referred to in the gaming industry as “gross revenue”) of the commercial gambling industry, mak-

ing them the second most lucrative form of legal gambling, eclipsed only by casinos (see Figure 3). That’s a very slight increase over 2001, when lotteries accounted for 27.0 percent. Lottery takeout increased by 5.9 percent between 2001 and 2002 (from \$17.6 billion to \$18.6 billion), keeping pace with total gambling takeout, which increased by 5.3 percent (from \$65.3 billion to \$68.7 billion).

Table 3
Lottery Sales and Profits, Fiscal Year 2003

State	Total Sales (\$ Millions)	Rank by Total Sales	Per Capita Sales (Dollars)	Rank by Per Capita Sales	Total Profit (Tax Revenue) (\$Millions)	Rank by Total Profits	Percent of Revenue Kept by State	Rank by % of Revenue Kept by State	Sales Change from FY 2002 to FY 2003	Implicit Tax Rate (3)	Rank by Implicit Tax Rate
Arizona	\$ 322.3	28	\$ 58.48	37	\$ 96.3	28	29.9%	21	9.3%	42.6%	21
California	2,781.6	5	78.92	29	1,026.5	3	36.9	4	- 4.6	58.5	4
Colorado	391.5	26	86.51	27	105.0	26	26.8	26	- 4.0	36.6	26
Connecticut	865.3	16	249.29	9	257.1	16	29.7	22	- 4.7	42.3	22
Delaware (1)	628.1	23	773.74	3	213.0	19	33.9	9	- 6.8	51.3	9
District of Columbia	\$ 237.6	30	\$ 419.64	6	\$ 72.0	30	30.3%	19	12.6%	43.5%	19
Florida	2,868.0	4	170.15	18	1,035.2	2	36.1	6	23.1	56.5	6
Georgia	2,604.4	6	302.33	7	751.5	8	28.9	23	6.3	40.6	23
Idaho	98.0	36	72.32	33	20.5	36	20.9	36	5.7	26.5	36
Illinois	1,585.6	11	125.64	24	540.3	11	34.1	8	- 0.3	51.7	8
Indiana	\$ 664.4	21	\$ 107.58	26	\$ 175.6	22	26.4%	27	6.1%	35.9%	27
Iowa	187.8	33	63.89	36	48.1	33	25.6	28	3.6	34.4	28
Kansas	210.8	32	77.58	30	64.3	32	30.5	17	10.9	43.9	17
Kentucky	673.5	20	164.11	19	180.8	21	26.8	25	5.4	36.7	25
Louisiana	311.5	29	69.43	35	111.1	25	35.7	7	- 0.1	55.4	7
Maine	\$ 164.6	34	\$ 126.59	23	\$ 39.3	34	23.8%	31	4.2%	31.3%	31
Maryland	1,322.6	12	241.36	10	444.9	12	33.6	10	1.2	50.7	10
Massachusetts	4,197.8	2	653.08	4	889.5	5	21.2	35	- 0.4	26.9	35
Michigan	1,783.4	10	177.25	14	586.0	10	32.9	13	5.6	48.9	13
Minnesota	351.8	27	69.78	34	79.4	29	22.6	32	- 6.7	29.1	32
Missouri	\$ 708.6	19	\$ 124.59	25	\$ 193.9	20	27.4%	24	21.1%	37.7%	24
Montana	34.7	39	37.94	39	7.5	39	21.5	33	3.1	27.4	33
Nebraska	80.9	37	46.68	38	20.0	37	24.7	29	9.5	32.8	29
New Hampshire	221.2	31	172.69	17	66.6	31	30.1	20	3.9	43.0	20
New Jersey	2,074.1	9	240.98	12	764.2	7	36.8	5	0.3	58.3	5
New Mexico	\$ 137.3	35	\$ 73.70	32	\$ 33.1	35	24.1%	30	2.5%	31.8%	30
New York	5,396.0	1	281.59	8	1,780.4	1	33.0	12	13.5	49.2	12
Ohio	2,078.2	8	181.94	13	641.4	9	30.9	15	4.8	44.6	15
Oregon (1)	853.2	17	241.01	11	387.7	14	45.4	1	4.4	83.3	1
Pennsylvania	2,133.0	7	172.75	16	787.7	6	36.9	3	10.3	58.6	3
Rhode Island (2)	\$ 1,290.5	13	\$ 1,203.55	1	\$ 241.8	17	18.7%	38	10.2%	23.1%	38
South Carolina	724.3	18	175.57	15	220.6	18	30.4	18	126.4	43.8	18
South Dakota (2)	647.0	22	848.60	2	112.0	24	17.3	39	2.7	20.9	39
Texas	3,130.7	3	142.77	21	955.2	4	30.5	16	5.5	43.9	16
Vermont	79.5	38	128.69	22	16.2	38	20.4	37	- 3.0	25.6	37
Virginia	\$ 1,135.7	14	\$ 154.79	20	\$375.2	15	33.0%	11	2.5%	49.3%	11
Washington	460.3	24	75.47	31	98.5	27	21.4	34	4.9	27.2	34
West Virginia (1)	1,081.9	15	598.53	5	411.0	13	38.0	2	27.5	61.3	2
Wisconsin	435.1	25	79.74	28	141.5	23	32.5	14	1.7	48.2	14
Total U.S.	\$ 44,952.6		\$ 155.33		\$13,990.6		31.1%		6.6%	45.2%	
Total of lottery states	44,952.6		176.93		13,990.6		31.1		6.6	45.2	
Average lottery state	1,152.6		232.55		358.7		29.2		5 (4)	42.4	

(1) Includes net VLT sales (cash in less cash out).

(2) Include gross VLT sales (cash in).

(3) The implicit tax rate measures the tax revenue (profits) as a percentage of the value of the lottery ticket (prize money plus administrative costs). The implicit tax rate does not take into account federal or state income tax on winnings.

(4) Does not include South Carolina, as the lottery there started in FY 2002 and experienced a large initial increase in sales from FY 2002 to FY 2003.

Note: FY’03 data is unaudited, and due to differences in reporting methods, data in this chart may not exactly match other sources’ data in other charts in this report.

Source: North American Association of State and Provincial Lotteries; Census Bureau population data; Tax Foundation calculations.

Total Consumer Spending on Lotteries

In terms of total consumer spending, lotteries brought in nearly \$45 billion during Fiscal Year 2003 (see Table 3). This is an increase of 6.6 percent over Fiscal Year 2002. From Fiscal Year 2001 to Fiscal Year 2002, sales increased by 8.4 percent. New York boasts the highest Fiscal Year 2003 sales (\$5.4 billion), followed by Massachusetts (\$4.2 billion) and Texas (\$3.1 billion). At the bottom of the list are Montana (\$34.7 million), Vermont (\$79.5 million) and Nebraska (\$80.9 million).

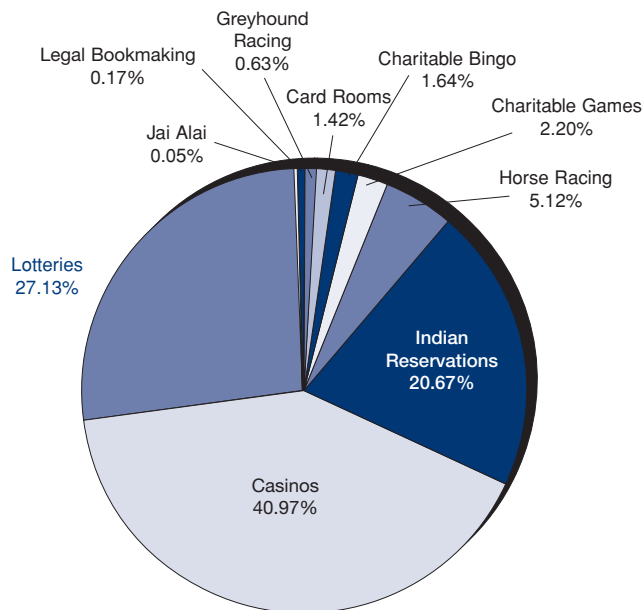
Per Capita Spending on Lotteries

Large and densely populated states have a clear advantage in terms of raising large amounts of revenue, so a better measure of a lottery's revenue-raising ability is per capita spending. In Fiscal Year 2003, the average American spent \$155.33 on lottery games. Taking into account only residents of lottery states, this figure rises to \$176.93. If slightly older data are used, lottery spending can be compared to other categories of consumer spending, including other types of recreational activities. In 2002, the average American spent more money on lotteries than on movies or reading materi-

als. (See Figure 4.) Per capita spending on movies (theater admissions only) was \$32.08; per capita spending on reading materials was \$140.00; and per capita spending on lotteries was \$147.12. The discrepancy between reading and lottery expenditures is especially large in the Northeast, where lottery spending is relatively high, and not quite as noticeable in the South. Westerners and Midwesterners spend more per capita on reading materials than on lottery tickets.

Per capita lottery spending varies greatly by state (see Table 3). It should be noted, however, that many people purchase lottery tickets in states where they do not reside, which may skew the per capita figures somewhat. Fiscal Year 2003 per capita lottery spending was highest by far in Rhode Island, with the average resident spending \$1,203.55 per year. South Dakota was a distant second at \$848.60 and Delaware was third, at \$773.74. It should be noted that all three states have VLT income, which may skew the results. If we look only at states without VLTs, the state with the highest per capita spending was Massachusetts at \$653.08, followed by the District of Columbia at \$419.64 and Georgia at \$302.33. At the other end of the spectrum are Montana (\$37.94), Nebraska (\$46.68) and Arizona (\$58.48). The median was Virginia, with \$154.79 spent per person.

Figure 3
Gross Gambling Revenue (Takeout) by Industry, 2002



***Note:** These amounts represent each industry's takeout (consumer spending minus prizes/winnings awarded) rather than total consumer spending.
Note: Due to differences in reporting methods, data in this chart may not exactly match other sources' data in other charts in this report.
Source: Data from Christiansen Capital Advisors in *International Gaming and Wagering Business*, August 2003; Tax Foundation calculations.

Spending by Type of Game

Lottery games are not all equal in terms of consumer spending (see Figure 5). Instant games bring in the most money, accounting for 47 percent of all sales in Fiscal Year 2003, or \$20.1 billion. Three- and four-digit numbers games are a distant second at 19 percent (\$8.5 billion). Third are state lotto games at 13 percent (\$5.9 billion), followed by multi-state lotto games (such as Powerball) at 8 percent (\$3.7 billion) and VLTs at 6 percent (\$2.8 billion). Keno is last, at \$2.1 billion, accounting for 5 percent of sales.

Despite the excitement generated by multi-state games with large jackpots, these games don't yet account for a large share of the total lottery market. Sales are increasing, however. The average multi-state game saw an increase of 44.58 percent in sales from Fiscal Year 2001 to Fiscal Year 2002, which prompted *Public Gaming International Magazine* to dub Fiscal Year 2002 the "Year of the Multi-State."³⁹

LOTTERY TAX REVENUE AS A PERCENTAGE OF TOTAL STATE REVENUE

In Fiscal Year 2002 the amount of money raised by lotteries did not comprise more than 7 percent

of any state's own-source general revenue. (See Table 5.) The amount ranged from a high of 7.10 percent in South Dakota to a low of 0.33 percent in Montana. Rhode Island had the second highest percentage (7.00 percent), followed by Delaware (6.20 percent) and West Virginia (6.13 percent). The top four states all have VLTs. After Montana, other

states with relatively low percentages were Nebraska (0.44 percent), Minnesota (0.50 percent) and New Mexico (0.53 percent). The average lottery state raised 2.26 percent of its own-source general revenue from lotteries. The median was 1.90 percent (Virginia).

Table 4
Lottery Revenue/Expense Analysis, Traditional (non-VLT) games only,
Fiscal Year 2003, (\$Millions)

State	Sales	Prizes	Gross Revenue (takeout, or sales minus prizes)	Operating Expenses	Operating Income	Government Revenue	Operating Income as a Percentage of Total Sales(2)	Operating Expenses as a Percentage of Total Sales(2)	Prizes as a Percentage of Total Sales(2)	Operating Income as a Percentage of Takeout(2)	Operating Expenses as a Percentage of Takeout(2)
Arizona	\$ 322.3	\$ 174.0	\$ 148.3	\$ 52.7	\$ 95.9	\$ 96.3	29.8%	16.4%	54.0%	64.7%	35.5%
California	2,781.6	1,451.8	1,329.8	362.3	967.4	1,121.9	34.8	13.0	52.2	72.8	27.2
Colorado	391.5	226.9	164.6	61.8	102.7	105.0	26.2	15.8	58.0	62.4	37.6
Connecticut (3)	865.3	523.9	341.4	83.3	258.4	260.3	29.9	9.6	60.5	75.7	24.4
District of Columbia	237.2	123.6	113.7	42.6	71.7	72.1	30.2	18.0	52.1	63.1	37.5
Delaware (4)	\$ 102.4	\$ 52.7	\$ 49.7	\$ 17.2	\$ 32.5	\$ 32.5	31.7%	16.8%	51.5%	65.4%	34.6%
Florida	2,868.0	1,555.8	1,312.1	292.7	1,024.6	1,153.5	35.7	10.2	54.2	78.1	22.3
Georgia	2,604.4	1,541.8	1,062.6	317.8	749.9	767.2	28.8	12.2	59.2	70.6	29.9
Idaho	98.2	56.6	41.6	19.7	21.9	22.0	22.3	20.1	57.6	52.6	47.4
Illinois (5)	1,564.7	885.2	679.5	168.9	535.8	536.1	34.2	10.8	56.6	78.8	24.9
Indiana	\$ 664.4	\$ 396.2	\$ 268.2	\$ 93.8	\$ 174.4	\$ 178.9	26.2%	14.1%	59.6%	65.0%	35.0%
Iowa	187.8	104.2	83.6	38.0	46.8	47.4	24.9	20.3	55.5	55.9	45.5
Kansas	202.9	107.7	95.3	32.4	63.8	63.8	31.5	16.0	53.0	67.0	34.0
Kentucky	673.5	402.2	271.3	91.2	180.1	198.2	26.7	13.5	59.7	66.4	33.6
Louisiana	311.5	155.9	155.5	46.8	108.8	111.0	34.9	15.0	50.1	69.9	30.1
Maine	\$ 164.6	\$ 99.9	\$ 64.8	\$ 26.6	\$ 40.2	\$ 40.3	24.4%	16.2%	60.7%	62.1%	41.1%
Maryland	1,322.2	743.4	578.8	140.1	438.7	438.5	33.2	10.6	56.2	75.8	24.2
Massachusetts (6)	4,191.1	3,008.4	1,182.7	306.7	887.9	889.5	21.2	7.3	71.8	75.1	25.9
Michigan (5)	1,681.5	899.7	781.9	199.3	583.7	564.2	34.7	11.9	53.5	74.7	25.5
Minnesota (7)	351.8	205.0	146.8	68.8	77.9	79.4	22.2	19.6	58.3	53.1	46.9
Missouri (5)	\$ 708.0	\$ 434.6	\$ 273.5	\$ 87.7	\$ 186.3	\$ 209.3	26.3%	12.4%	61.4%	68.1%	32.1%
Montana	34.7	17.6	17.1	9.7	7.5	7.5	21.5	27.9	50.6	43.6	56.5
New Hampshire (6)	221.2	130.0	91.2	27.0	66.2	66.6	29.9	12.2	58.8	72.6	29.6
Nebraska	80.9	43.0	37.9	18.5	19.5	20.0	24.1	22.8	53.1	51.3	48.7
New Jersey (5)	2,073.8	1,171.5	902.4	189.6	751.9	754.0	36.3	9.1	56.5	83.3	21.0
New Mexico	\$ 137.0	\$ 77.7	\$ 59.4	\$ 26.5	\$ 32.8	\$ 33.1	23.9%	19.4%	56.7%	55.2%	44.7%
New York	5,396.0	3,061.7	2,334.2	547.0	1,787.2	1,910.6	33.1	10.1	56.7	76.6	23.4
Ohio	2,078.3	1,208.2	870.1	237.9	637.1	708.0	30.7	11.4	58.1	73.2	27.3
Oregon (4)	354.8	248.7	106.1	59.9	62.5	62.5	17.6	16.9	70.1	58.9	56.5
Pennsylvania	2,133.0	1,124.6	1,008.4	222.0	786.5	787.7	36.9	10.4	52.7	78.0	22.0
Rhode Island (6)	\$ 239.0	\$ 144.2	\$ 94.8	\$ 33.0	\$ 66.3	\$ 67.2	27.7%	13.8%	60.3%	69.9%	34.8%
South Carolina	724.3	415.7	308.6	91.3	219.9	219.3	30.4	12.6	57.4	71.3	29.6
South Dakota (4)	28.6	15.8	12.8	6.4	6.4	6.9	22.5	22.4	55.3	50.4	50.1
Texas	3,130.7	1,845.2	1,285.5	318.5	967.9	937.7	30.9	10.2	58.9	75.3	24.8
Vermont	79.4	51.4	28.0	12.3	15.8	16.2	19.8	15.4	64.7	56.3	43.8
Virginia	\$ 1,135.7	\$ 638.2	\$ 497.6	\$ 131.8	\$ 365.8	\$ 375.2	32.2%	11.6%	56.2%	73.5%	26.5%
Washington	460.4	298.0	162.4	65.5	96.8	130.1	21.0	14.2	64.7	59.6	40.4
West Virginia (4)	192.1	114.7	77.4	33.5	44.9	31.6	23.4	17.5	59.7	58.0	43.3
Wisconsin (1)	435.0	248.5	186.5	64.2	122.4	133.1	28.1	14.8	57.1	65.6	34.4
Total	\$ 41,229.9	\$ 24,003.9	\$ 17,226.0	\$ 4,645.5	\$ 12,706.7	\$ 13,254.5	30.8%	11.3%	58.2%	73.8%	27.0%

(1) Unaudited

(2) Totals may not equal 100% due to differences in states' reporting methods.

(3) Connecticut operating and government revenues include funding for regulation and chronic gamblers fund.

(4) Results from video lottery operations are not included.

(5) Revenue to government in Illinois, Michigan, Missouri, New Jersey and Rhode Island includes unclaimed prize fund/forfeited prizes.

(6) Government revenue includes net proceeds from the charitable gaming divisions of lotteries in Massachusetts, New Hampshire and Rhode Island.

(7) Minnesota government revenue includes taxes-in-lieu-of-sales-tax, compulsive gambling fund and unclaimed prizes paid to state.

Note: Due to differences in reporting methods, data in this chart may not exactly match other sources' data in other charts in this report.

Source: Data from *International Gaming and Wagering Business* 25 (June 2004); Tax Foundation calculations

EARMARKING

Lottery revenues are usually allocated, or “earmarked,” for specific programs. All but seven states specify uses for proceeds and the rest simply transfer the proceeds to the state’s general fund (see Table 1). Some states earmark part of the proceeds for specific programs and transfer the rest to the general fund. Massachusetts distributes the proceeds to cities and towns, who are free to spend it as they wish—in effect, a general fund. Uses for which proceeds have been earmarked include: parks and recreation (Colorado), senior citizens programs (Pennsylvania), salmon restoration (Oregon), juvenile detention (Montana), pension relief fund for police officers and fire fighters (Indiana), affordable housing trust fund (Kentucky) and lower license plate taxes (Indiana). Ironically, three states (Iowa, Nebraska and North Dakota) give part of the proceeds to research or treatment programs for gambling addiction, and five others (Kansas, Massachusetts, Minnesota, Montana and Nebraska) have used proceeds for this purpose in the past. South Dakota and Wisconsin use part of the proceeds to help lower property taxes. Lottery funds have also been used to build stadiums, enhance mass transit, aid local food banks and fund programs for Vietnam veterans.

The most common program for which revenue is earmarked is education. Twenty-three states earmark all or part of their proceeds for education, with 21 of them for elementary and secondary education only or a combination of elementary/secondary and college. Two states, Tennessee and New Mexico, earmark profits solely for college. Collectively, states have reportedly earmarked over \$110 billion for education from the start of the first lottery in 1964 through Fiscal Year 2002 (not counting South Carolina, which started a lottery in

2002).⁴⁰ A few states make the intended use of proceeds clear in the name of the lottery itself, e.g., the South Carolina Lottery for Education and the Tennessee Education Lottery Corporation.

In California there was a protracted battle over lottery enactment, with education as one of the deciding factors. A heated, two-decade battle over a proposed lottery finally ended in 1986 with a successful ballot initiative, thanks in part to the efforts of Scientific Games, Inc., a supplier of lottery products. Scientific Games, Inc. led a coalition called Californians for Better Education, which was instrumental in placing the initiative on the ballot. The coalition spent \$2 million, most of which was contributed by Scientific Games, Inc.⁴¹ This demonstrates not only the political fervor generated by lotteries and the lengths corporations with a vested interest will go to, but also the pull that public education has on the voting public.

While lotteries have ostensibly raised a large amount of money for “education,” it is not clear that the funds are always used for the causes for which they are earmarked. Skeptics say that earmarking is at best ineffective and at worst a misleading political tactic to persuade voters to approve lottery referenda and play the lottery. Legislators can simply shuffle funds; lottery revenue allows them to use the money that would have been allocated for education for other purposes. Voters and lottery players, however, may be under the impression that lottery funds will significantly increase the total amount of money spent on education. Therefore, voters may be misled when they approve lottery referenda or initiatives, and consumers may be misled when they play the lottery and assume that if they do not win, at least the money will benefit public education. Indeed, one survey showed that 54 percent of respondents consid-

³⁹ Public Gaming Research Institute, “U.S. Fiscal Year Summary: FY’02: The Year of the Multi-State,” *Public Gaming International Magazine* (September, 2002): 14.

⁴⁰ North American Association of State and Provincial Lotteries, “Cumulative Lottery Proceeds by Program—Lotteries Making a Difference,” available at <http://www.naspl.org/benefits.html>.

⁴¹ Clotfelter and Cook, *Selling Hope*, 151-154.

⁴² GTech Corporation, 10.

⁴³ See, for example, Charles J. Spindler, “The Lottery and Education: Robbing Peter to Pay Paul?” *Public Budgeting and Finance* 15 (Fall 1995): 54-62, quoted in Charles T. Clotfelter, Philip J. Cook, Julie A. Edell and Marian Moore, “State Lotteries at the Turn of the Century: Report to the National Gambling Impact Study Commission” (Washington, DC: Government Printing Office, 1999), 6; Noel D. Campbell, “Do Lottery Funds Increase Educational Expenditure?: Evidence from Georgia’s Lottery for Education” *Journal of Education Finance* 28 (Winter 2003): 383-402; Donald E. Miller and Patrick A. Pierce, “Lotteries for Education: Windfall or Hoax?” *State and Local Government Review* 29 (1997): 34-42; William N. Evans and Ping Zhang, “The Impact of Earmarked Lottery Revenue on State Educational Expenditures,” working paper, University of Maryland (November 2002); and Clotfelter and Cook, *Selling Hope*, 166.

⁴⁴ Clotfelter and Cook, “State Lotteries,” 6.

⁴⁵ Evans and Zhang, 1.

⁴⁶ *Ibid.*, 31.

⁴⁷ South Carolina Education Lottery, “How Education Wins,” <http://www.sceducationlottery.com/HowEducationWins.asp>, May 13, 2004.

ered education the most appropriate use of lottery proceeds and 65 percent would be more likely to play the lottery if proceeds were earmarked for a specific purpose.⁴²

The relevance of the earmarking controversy is apparent when one considers that lotteries may be the only tax that politicians: 1) actively, enthusiastically lobby for, 2) do so without acknowledging that a lottery is, for all intents and purposes, a tax, 3) ask citizens to approve in initiatives or referenda, and d) remove longstanding state constitutional bans in order to enact. The purported and actual uses of proceeds are therefore relevant insofar as they affect voters' decisions to approve a lottery.

A number of studies have attempted to prove or disprove the suspicion that earmarked funds are fungible and tend to simply replace rather than supplement education expenditures,⁴³ but of course it is impossible to know how much money would have been spent on education in the absence of lottery funds. However, there is not much evidence that these funds add significantly to the total amount of money spent on public education. In 1999 the National Gambling Impact Study Commission concluded that there was no reliable way to know whether earmarked money was using for the intended purpose: "When expenditures on the earmarked purpose far exceed the revenues available from the lottery, as is the case with the general education budget, there is no practical way of preventing a legislature from allocating general revenues away from earmarked uses, thus blunting the purpose of the earmarking."⁴⁴

To be fair, not everyone agrees on the impact of earmarking. One study found that every lottery dollar that goes to the state increases K-12 education spending by about 30 to 50 cents, and a dollar of earmarked lottery proceeds probably generates more education spending than a dollar of non-earmarked proceeds.⁴⁵ The same study concluded, "Though our findings suggest that earmarking lottery revenue to K-12 education increases spending, a handsome fraction of earmarked money is fungible. There is a high likelihood that a dollar of earmarked lottery profits generates less than a dollar of spending on K-12 education."⁴⁶

While lottery agencies are generally enthusiastic about the effects of their contributions to education, they are not unaware of the controversy and the potential for misallocation. South Carolina, for example, states in its 2002 lottery legislation: "[P]roceeds of lottery games must be used to support improvements and enhancements for educational purposes and programs as provided by the General Assembly and that the net proceeds must

be used to supplement, not supplant, existing resources for educational purposes and programs."⁴⁷

Montana, however, had a different experience. In 1995, after nearly twenty years of earmarking proceeds for education, the state legislature began transferring revenue to the general fund instead. The president of the Montana Education Association stated that it was an "illusion" that lottery funds significantly benefited public schools.⁴⁸ New York has also had its share of doubts about earmarking. According to a former New York state comptroller, "Most of us have fallen for the myth that lottery money is used to increase funding for education. But that's just a myth. The lottery money has never supplemented state aid—not yesterday, not today, and, most likely not tomorrow."⁴⁹

Table 5
Lottery Revenue as a Percentage of Own-Source General Revenue, Fiscal Year 2002

State	Percentage	Rank	State	Percentage	Rank
Arizona	0.83%	29	Montana	0.33%	37
California	1.09%	25	Nebraska	0.44%	36
Colorado	1.11%	23	New Hampshire	2.19%	16
Connecticut	2.35%	12	New Jersey	3.01%	9
Delaware (1)	6.20%	3	New Mexico	0.53%	34
District of Columbia	N/A	N/A	New York	2.86%	10
Florida	2.74%	11	Ohio	2.30%	14
Georgia	4.15%	6	Oregon (1)	4.08%	7
Idaho	0.68%	31	Pennsylvania	2.28%	15
Illinois	1.92%	18	Rhode Island (2)	7.00%	2
Indiana	1.21%	22	South Carolina (3)	0.97%	N/A (3)
Iowa	0.63%	32	South Dakota (2)	7.10%	1
Kansas	0.95%	27	Texas	2.34%	13
Kentucky	1.57%	20	Vermont	0.78%	30
Louisiana	0.97%	26	Virginia	1.90%	19
Maine	1.07%	25	Washington	0.57%	33
Maryland	3.07%	8	West Virginia (1)	6.13%	4
Massachusetts	4.27%	5	Wisconsin	0.87%	28
Michigan	2.09%	17			
Minnesota	0.50%	35	Average state (4)	2.26%	
Missouri	1.35%	21	All states (4)	2.09%	

(1) Includes net VLT sales (Cash in less cash out)

(2) Include gross VLT sales (Cash in)

(3) Lottery started midway through FY 2002, so this figure is not comparable to other states' percentages.

(4) This figure does not include South Carolina.

Note: Due to differences in reporting methods, data in this chart may not exactly match other sources' data in other charts in this report.

Note: Due to a methodological problem with currently available Census Bureau lottery data, we were unable to use Census Bureau figures for lottery revenues in this chart (see Methodology section).

Source: Data from North American Association of State and Provincial Lotteries; Census Bureau, State Government Finances; Tax Foundation calculations

As Table 6 shows, among states with lotteries as of School Year 1999-2000, those that earmarked revenue for K-12 education actually spent slightly less money per pupil than states that did not earmark: \$7,626 vs. \$7,838. This means states that earmarked spent about 3 percent less than states that did not earmark.

Lottery states overall spent more per pupil than non-lottery states: in School Year 1999-2000, the average lottery state spent \$7,738 per pupil and the average non-lottery state spent \$6,386. This means lottery state spent 21 percent more per pupil and the average non-lottery state. However, this is not necessarily due to the presence of lotteries. If we look at the 38 jurisdictions that had lotteries as of School Year 1999-2000 and compare them to the 13 states that did not have lotteries at that point, we can see that the lottery states have consistently spent more money per pupil than the non-lottery states—even before they had lotteries. In School Year 1959-1960—five years before the start of the first lottery—these 38 jurisdictions spent 18 percent more per pupil than the 13 states without lotteries as of School Year 1999-2000 (\$2,158 vs. \$1,826).

Another measure of the amount of money spent on education is the percentage of direct general state and local expenditures spent on K-12 education in each state. As Chart 7 shows, lottery states spent more as a percentage of the budget than did non-lottery states—22.0 percent vs. 19.3 percent. However, states that had lotteries as of FY 2000 spent a larger percentage of their budgets on education not only in FY 2000, but also in FY 1970, when only two states had established lotteries (24.1 percent vs. 26.3 percent) and in FY 1960, when no state had a lottery (22.9 percent vs. 23.4 percent).

As for the question of whether earmarking for education increases the percentage of the budget spent on education, in FY 2000 states with K-12 education earmarking spent 22.7 percent of direct general expenditures on K-12 education, compared with 21.5 percent in lottery states without earmarking. Here again, the difference in spending between these two groups of states can be seen as far back as 1959, so there is no reason to assume that earmarking of proceeds is the cause of the spending difference.

Perhaps the best measure of the effect of lotteries and earmarking on education is a comparison of

non-lottery states with lottery states that earmark for K-12 education. In FY 2000 non-lottery states spent 19.3 percent of direct general state and local expenditure on K-12 education, while lottery states that earmarked for education spent 22.7 percent. Once again, the spending difference between these two groups of states has existed for over 40 years. States that had lotteries as of FY 2000 and earmarked proceeds for education spent 23.6 percent of their budget on education in FY 1960, compared to 22.9 percent for non-lottery states. The gap between the two groups of states has widened slightly since the enactment of the first lotteries, both as a dollar amount and as a percentage of the budget, but not enough to assume lotteries and earmarking are solely responsible.

Not all states have had the same experience with earmarking. In Florida, for example, the percentage of the budget spent on education decreased after the lottery started, while in Georgia it increased. In New Hampshire it has waxed and waned several times. Of course the percentage of state and local expenditures spent on education does not tell the whole story, since other spending areas may have risen or fallen more dramatically than education, changing the portion spent on education.

It is hard to draw conclusions about earmarking from these data, since it is impossible to know how much money would have been spent on education in the absence of lotteries, but regardless of which method of comparison is used—per pupil spending in dollar amounts or education spending as a percentage of state/local expenditures—it does not appear that lotteries and earmarking have significantly raised K-12 education spending. Any effect that may exist is small and it is impossible to verify lotteries as the source.

There may be other fundamental differences between lottery states (especially those that earmark for education) and non-lottery states that cause lottery states to spend slightly more on education. As previously discussed, there are economic and political differences between the two groups of states, especially between states that started lotteries relatively early and those that started them late or not at all. These differences may lead states both to start lotteries and to spend more on education. Other factors may complicate the situation, such as differ-

⁴⁸ Evans and Zhang, 30.

⁴⁹ National Association of State Auditors, Comptrollers and Treasurers, *NASACT News* 18 (May 1998), 5.

⁵⁰ Melissa Schettini Kearney, "State Lotteries and Consumer Behavior," working paper, (Cambridge, MA, National Bureau of Economic Research, 2002) 3.

⁵¹ GTech Corporation, 8.

ences among states in cost of living (which could affect teachers' salaries), efficiency in use of education funds, the size of the student population and the importance accorded to public education by voters in each state. The enactment of a lottery, especially one designated specifically for education, may be a sign that legislators and/or voters in that state are ready to increase education spending and will do so with or without the presence of a lottery.

In any case, it does not appear that earmarking lottery funds for K-12 education significantly increases the amount of money spent on education. Some of the funds originally allocated for education are most likely displaced by lottery revenue. Lottery supporters, however, continue to promote lotteries as a way of supporting public education, and voters seem to believe the promise.

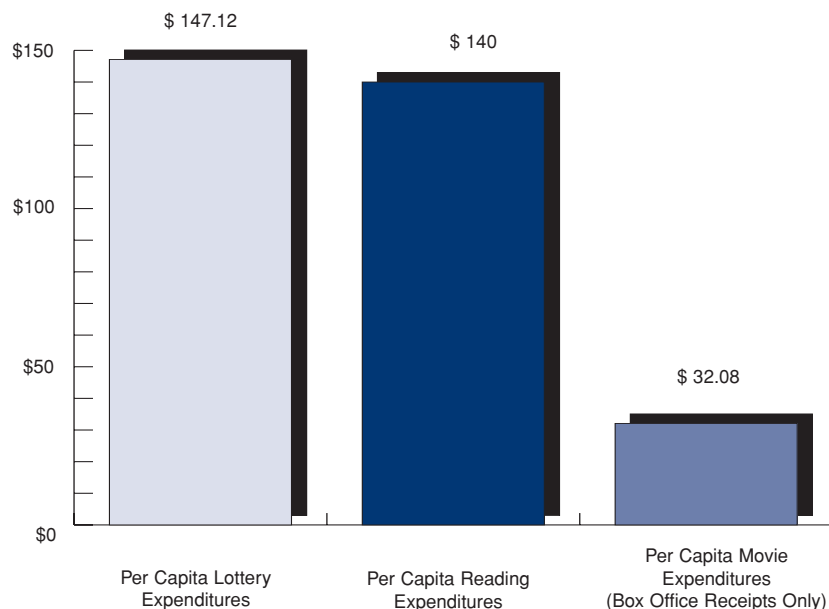
Economic Impact of State Lotteries

Other questions have been raised about the economic impact of state lotteries, in terms of both taxes and spending. It has been argued that money spent on lottery tickets displaces other spending and even lowers sales tax collections. One study concluded that lottery spending does not substitute for

other forms of gambling; instead, it crowds out 2 percent of other household consumption, or \$23 per month per adult in lottery states, with the most pronounced effect in low-income households.⁵⁰ Many people believe that lotteries help state governments keep their taxes lower.⁵¹ However, the state/local tax burden (taxes as a percentage of income) in 2003 was higher in the average lottery state (10.1 percent) than in the average non-lottery state (9.5 percent). (Data used for this calculation come from the Bureau of Economic Analysis, which does not count lottery revenue as tax revenue. Tax Foundation calculations of Tax Freedom Day also do not include lottery data, for the same reason.)

It has also been argued that lotteries are inefficient, expensive to administer, and a volatile, unreliable revenue source. For the most part, lottery sales and government proceeds continue to increase every year (see Table 3). Total U.S. sales increased 6.6 percent from Fiscal Year 2002 (\$42.154 billion) to Fiscal Year 2003 (\$44.953 billion) and total U.S. "profits" (tax revenue, or transfers to state treasuries) during this time increased by 4.8 percent (from \$13.347 billion to \$13.991 billion). The average state saw a 5 percent increase in sales (this figure does not include South Carolina, which had an unusually large sales increase due to the fact that the lottery started midway through FY 2002).

Figure 4
Lottery Spending vs. Spending on Other Leisure Activities
Fiscal Year 2002



Source: North American Association of State and Provincial Lotteries; Bureau of Labor Statistics, Consumer Expenditure Survey; Motion Picture Association of America; Tax Foundation calculations.

Note: South Carolina was included in this calculation although its lottery started in the middle of FY 2002 (January 2002)

Note: Due to differences in reporting methods, data in this chart may not exactly match other sources' data in other chart in this report.

Table 6

*Expenditure per Pupil in Average Daily Attendance in Public Elementary and Secondary Schools, Selected School Years, 1959–2000, in Constant 1999–2000 Dollars**

Numbers with blue background indicate years lottery was in operation. **Numbers with black background** indicate years lottery was in operation but not earmarking funds for education.

State	School Year						State	School Year					
	1959–1960	1969–1970	1979–1980	1989–1990	1994–1995	1999–2000		1959–1960	1969–1970	1979–1980	1989–1990	1994–1995	1999–2000
Lottery States (as of FY 2000) That Earmark All or Part of Proceeds for K-12 Public Education or Have Previously Earmarked Funds for Education							Massachusetts	2,356	3,850	6,148	8,316	8,202	9,317
California**	\$ 2,443	\$ 3,886	\$ 4,945	\$ 5,854	\$ 5,619	\$ 6,401	Minnesota	2,450	4,050	5,205	6,627	6,753	7,499
Florida	1,830	3,282	4,119	6,663	6,436	6,383	New Mexico	2,090	3,168	4,435	4,686	5,152	5,835
Georgia	1,460	2,635	3,544	5,699	5,845	6,903	Pennsylvania	\$ 2,359	\$ 3,952	\$ 5,527	\$ 8,304	\$ 8,002	\$ 8,380
Idaho	1,669	2,704	3,618	4,103	4,738	5,644	Rhode Island	2,382	3,994	5,672	8,490	8,683	9,646
Illinois	2,526	4,076	5,640	6,823	6,906	8,084	South Dakota	1,998	3,092	4,160	4,975	5,375	6,037
Michigan	\$ 2,392	\$ 4,051	\$ 5,758	\$ 7,395	\$ 7,873	\$ 8,886	West Virginia	1,489	3,002	4,188	5,814	6,874	7,637
Missouri	1,982	3,175	4,222	6,009	6,059	6,764	Wisconsin	2,380	3,956	5,401	7,365	7,800	8,299
Montana	2,367	3,504	5,400	6,315	6,407	6,990	Non-Lottery States (as of FY 2000)						
Nebraska	1,942	3,300	4,688	6,455	6,680	7,360	Alabama	\$ 1,389	\$ 2,438	\$ 3,515	\$ 4,436	\$ 4,958	\$ 5,758
New Hampshire	2,001	3,240	4,178	7,072	6,594	7,082	Alaska	3,148	5,031	10,309	11,241	10,089	9,668
New Jersey	\$ 2,233	\$ 4,554	\$ 6,959	\$ 10,852	\$ 11,002	\$ 10,903	Arkansas	1,297	2,544	3,433	4,646	5,018	5,628
New York	3,236	5,946	7,550	10,748	10,831	10,957	Hawaii	1,870	3,767	5,063	5,931	6,841	7,090
Ohio	2,103	3,272	4,524	6,726	6,935	7,816	Mississippi	1,186	2,245	3,628	4,125	4,592	5,356
Oregon	2,583	4,144	5,870	7,299	7,244	8,129	Nevada	\$ 2,480	\$ 3,448	\$ 4,554	\$ 5,489	\$ 5,808	\$ 6,148
Texas	1,915	2,797	4,177	5,534	5,878	6,771	North Carolina	1,367	2,744	3,826	5,720	5,714	6,505
Vermont	\$ 1,982	\$ 3,617	\$ 4,355	\$ 8,302	\$ 7,597	\$ 8,799	North Dakota	2,113	3,090	4,187	5,585	5,397	6,078
Virginia	1,580	3,172	4,296	6,228	5,996	6,491	Oklahoma	1,794	2,709	4,201	4,677	5,454	5,770
Washington	2,422	4,102	5,600	6,269	6,647	6,914	South Carolina	1,268	2,745	3,821	5,442	5,400	6,545
Lottery States with No Earmarking for K-12 Public Education							Tennessee	\$ 1,372	\$ 2,537	\$ 3,566	\$ 4,885	\$ 4,939	\$ 5,837
Arizona	\$ 2,325	\$ 3,227	\$ 4,298	\$ 5,404	\$ 5,378	\$ 5,444	Utah	1,858	2,807	3,613	3,685	4,115	4,692
Colorado	2,282	3,307	5,279	6,293	6,126	6,702	Wyoming	2,595	3,836	5,510	7,436	6,933	7,944
Connecticut	2,513	4,263	5,278	10,449	9,924	10,122	United States total	\$ 2,161	\$ 3,657	\$ 4,954	\$ 6,639	\$ 6,741	\$ 7,392
Delaware	2,626	4,034	6,239	7,731	7,912	8,809	Average State	2,074	3,469	4,878	6,631	6,728	7,393
District of Columbia	2,484	4,564	7,107	11,939	10,507	11,935	Average non-lottery state***	1,826	3,072	4,556	5,638	5,789	6,386
Indiana	\$ 2,124	\$ 3,263	\$ 4,105	\$ 6,141	\$ 6,558	\$ 7,652	Average lottery state***	\$ 2,158	\$ 3,605	\$ 4,988	\$ 6,971	\$ 7,049	\$ 7,738
Iowa	2,119	3,783	5,073	5,937	6,172	6,925	Average earmarking lottery state***	2,148	3,637	4,969	6,908	6,960	7,626
Kansas	2,003	3,455	4,739	6,335	6,548	6,962	Avg. non-earmarking lottery state***	2,168	3,576	5,006	7,027	7,129	7,838
Kentucky	1,343	2,443	3,710	4,993	5,872	6,784							
Louisiana	2,143	2,904	3,908	5,204	5,358	6,256							
Maine	\$ 1,629	\$ 3,103	\$ 3,976	\$ 7,164	\$ 7,235	\$ 8,247							
Maryland	2,263	4,116	5,665	8,367	8,155	8,273							

* Based on the Consumer Price Index, prepared by the Bureau of Labor Statistics, U.S. Department of Labor, adjusted to a school-year basis.

These data do not reflect differences in inflation rates from state to state.

** Estimated by the National Center for Education Statistics.

*** As of 1999–2000

Note: Beginning in 1980–81, state administration expenditures are excluded. Beginning in 1989–90, extensive changes were made in the data collection procedures. There are discrepancies in average daily attendance reporting practices from state to state. Some data have been revised from previously published figures.

Note: The following states did not earmark funds for K-12 education as of School Year 2000, but currently do: Washington, as of 2001; South Carolina, as of 2002; Tennessee, as of 2004.

Source: U.S. Department of Education, National Center for Education Statistics, Statistics of State School Systems; and Common Core of Data surveys; Tax Foundation calculations.

Table 7

*K-12 Public Education Expenditures as a Percentage of Direct General State and Local Expenditures
Selected Fiscal Years, 1960–2000*

Numbers with blue background indicate years lottery was in operation. Numbers with black background indicate years lottery was in operation but not earmarking funds for education.

State	1960	1970	1980	1990	1995	2000	State	1960	1970	1980	1990	1995	2000
States That Earmark Proceeds for Public Education K-12 as of FY 2000 Or Have Previously Earmarked for Education							Massachusetts	21.1	23.2	25.6	20.6	20.3	22.5
California*	24.6%	22.8%	21.1%	19.4%	17.8%	19.5%	Minnesota	23.7	28.2	23.1	20.3	19.4	19.7
Florida	19.5	26.8	21.7	20.1	19.1	18.4	New Mexico	24.8	27.0	23.9	20.6	19.6	18.7
Georgia	23.7	23.9	21.5	22.9	21.1	24.1	Pennsylvania	25.2%	27.2%	26.3%	26.7%	23.0%	21.4%
Idaho	22.4	24.5	24.4	23.7	21.9	22.4	Rhode Island	22.2	24.8	21.8	21.8	21.7	25.1
Illinois	22.9	28.3	25.3	23.5	21.8	22.5	South Dakota	23.3	25.7	21.8	23.0	21.8	21.4
Michigan	25.5%	29.9%	26.7%	25.8%	25.2%	25.6%	West Virginia	26.9	25.6	22.9	28.4	24.6	24.0
Missouri	24.1	24.9	23.9	26.3	24.1	22.8	Wisconsin	22.1	25.4	22.5	23.6	23.5	22.3
Montana	23.9	27.1	25.7	25.5	23.9	22.0	Non-Lottery States, as of FY 2000						
Nebraska	23.1	27.1	24.0	25.6	24.0	22.9	Alabama	24.1%	24.3%	22.2%	20.9%	19.2%	18.9%
New Hampshire	19.8	25.6	23.9	25.0	23.4	25.0	Alaska	26.2	19.9	15.1	15.6	16.3	15.6
New Jersey	29.3%	31.0%	29.3%	27.2%	25.5%	28.2%	Arkansas	23.7	25.8	24.3	26.2	23.4	21.5
New York	22.0	24.5	22.6	20.1	19.4	20.3	Hawaii	17.9	17.7	18.7	15.9	15.3	16.6
Ohio	23.8	28.8	24.8	24.9	22.8	22.5	Mississippi	19.9	22.6	22.2	22.3	19.9	18.0
Oregon	25.4	27.9	22.5	23.8	20.4	19.3	Nevada	19.6%	21.0%	18.9%	17.3%	18.4%	19.2%
Texas	25.6	27.0	25.8	27.0	25.9	26.2	North Carolina	26.7	28.7	24.6	23.2	19.8	19.1
Vermont	18.9%	24.5%	23.2%	27.0%	26.6%	25.3%	North Dakota	19.8	24.1	19.0	21.2	19.3	17.4
Virginia	24.5	29.1	24.4	23.7	22.9	22.3	Oklahoma	23.0	23.0	24.8	22.6	24.6	24.6
Washington	25.1	27.0	24.8	21.4	19.5	19.1	South Carolina	26.7	31.1	25.2	23.3	20.4	20.2
States with No Earmarking for K-12 Education							Tennessee	22.6%	24.3%	22.3%	22.0%	18.6%	19.5%
Arizona	25.5%	25.3%	22.6%	17.3%	19.8%	18.3%	Utah	25.4	26.7	22.0	22.8	21.1	19.1
Colorado	22.6	26.1	27.3	22.9	20.6	19.5	Wyoming	21.3	23.9	20.6	23.6	22.0	20.5
Connecticut	23.3	28.6	25.0	25.7	25.0	25.2	United States total	23.8%	26.1%	23.7%	22.6%	21.3%	21.5%
Delaware	22.2	25.1	25.0	20.2	19.9	20.0	Average state	23.3	25.7	23.1	22.8	21.5	21.3
District of Columbia	16.9	18.5	15.7	15.9	15.5	15.1	Average non-lottery state**	22.9	24.1	21.6	21.3	19.9	19.3
Indiana	26.6%	30.2%	27.1%	26.7%	24.8%	24.7%	Average lottery state**	23.4%	26.3%	23.7%	23.3%	22.1 %	22.0%
Iowa	24.4	29.0	24.2	22.7	21.9	21.0	Average earmarking lottery state**	23.6	26.7	24.2	24.0	22.4	22.7
Kansas	24.2	26.5	22.1	24.7	23.5	23.1	Avg. non-earmarking lottery state**	23.2	25.9	23.2	22.8	21.7	21.5
Kentucky	21.9	20.5	19.5	22.2	21.9	20.2							
Louisiana	21.8	24.5	19.9	22.0	18.7	19.7							
Maine	20.6%	28.4%	24.4%	26.1%	24.7%	23.1%							
Maryland	25.0	27.4	23.4	23.4	24.0	23.8							

* For FY 1960, Includes an estimated \$144,942,000 for summer schools, adult education, and community colleges.

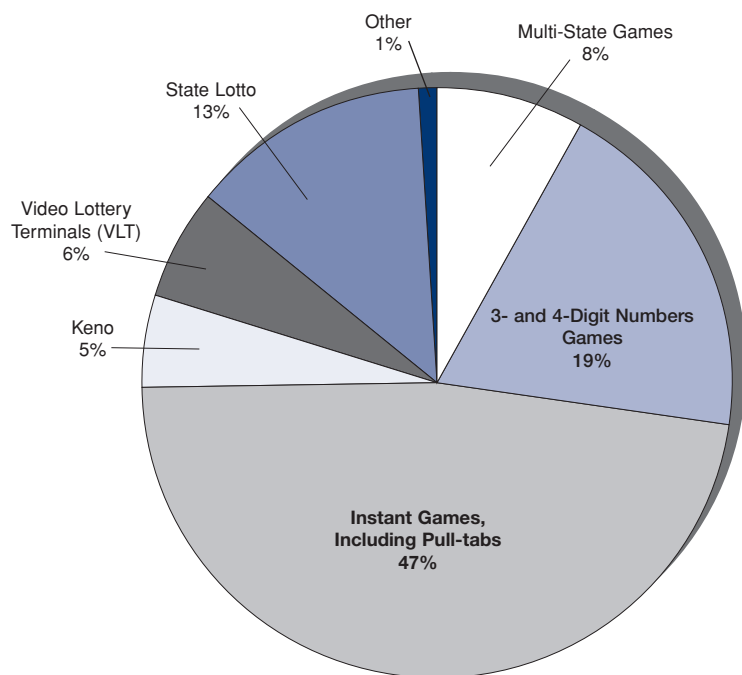
** As of 1999–2000

Note: Beginning in 1980–81, expenditures for state administration are excluded.

Note: The following states did not earmark funds for K-12 education as of Fiscal Year 2000, but currently do: Washington, as of 2001; South Carolina, as of 2002; Tennessee, as of 2004.

Source: U.S. Department of Education, National Center for Education Statistics, Statistics of State School Systems, and Common Core of Data surveys; Bureau of the Census, State and Local Government Finances; Tax Foundation calculations.

Figure 5
Lottery Sales by Type of Game,
Fiscal Year 2003



Note: VLT sales denotes net machine income except for South Dakota, which reports cash-in data.

Note: Due to rounding, percentages do not add up to 100%.

Source: Data from *La Fleur's Magazine*, Vol. 11 No.7 (Sept. 2003); Tax Foundation Calculations.

However, there are exceptions. From Fiscal Year 2002 to Fiscal Year 2003, nine states saw a drop in total sales, ranging from 0.1 percent in Louisiana to 6.8 percent in Delaware, and 15 saw a drop in proceeds, ranging from a modest 0.02 percent in Iowa to 7.4 percent in Delaware. Washington suffered a 28 percent drop in proceeds from Fiscal Year 2001 to Fiscal Year 2002. One state, Vermont, has had declining proceeds three years in a row. While most states continue to enjoy increasing sales and “profits,” it could still be problematic for a state to rely too heavily on a revenue source that is not more predictable, especially if a neighboring state enacts a lottery.

Is the Lottery a Tax?

The discussion of issues such as earmarking, government revenue and state spending raises the question, Is the lottery a tax? No government—state or federal—labels it as such (although Minnesota does consider part of its ticket sales to be an “in-lieu-of-sales tax” of 6.5 percent). However, despite the lack of a formal definition as a tax by a

government agency, lottery “profits” constitute an implicit tax.

THE VOLUNTARY NATURE OF LOTTERY PURCHASES

Lottery proponents often argue that a tax is a mandatory or compulsory payment and lottery purchases are voluntary, so the lottery cannot be a tax. This argument overlooks the fact that the purchase is voluntary, not the tax, just as a sales or excise tax is compulsory on a voluntary purchase. A mandatory tax on a voluntary purchase is still a tax. In fact, all taxed purchases and activities are technically voluntary. The same argument applies to the sale of alcohol or tobacco: one is no more required to purchase a lottery ticket than to purchase alcohol or tobacco, yet excise taxes on alcohol and tobacco are still considered taxes.

At the heart of the spurious if-it’s-voluntary-it-can’t-be-a-tax argument is the assumption that, since the lottery is a recreational activity, not a necessity, only people who can afford it and enjoy it—those who are willing and able to pay for tickets—will participate. Presumably, government revenue that is contributed enthusiastically and voluntarily is preferable to revenue that is contributed under duress. This argument seems to suggest that the lottery is akin to a sort of user fee, or a charge paid to the government for a specific service, by the people who use that service, e.g., fees for the use of publicly owned parking facilities or camp grounds.

TYPES OF GOVERNMENT REVENUE

An understanding of the different categories of government revenue can help shed some light on the classification of lottery revenue.

The Census Bureau Government Finance and Employment Classification Manual considers lottery proceeds “miscellaneous general revenue,” and lotteries a “general government activity.” The Census Bureau divides government revenue into six basic categories.

- Intergovernmental revenue
- Insurance trust revenue
- Utility and liquor store revenue

Examples: Revenue from state-run liquor stores; utilities such as public mass transit, operations of public electric power supply systems and operations of public water supply systems

- Tax revenue: “Compulsory contributions exacted by a government for public purposes, other than

from special assessments for capital improvements and from employee and employer contributions or 'taxes' for retirement and social insurance systems."

Examples: Individual income tax, property tax, death and gift tax, general sales tax, motor fuels sales tax, alcoholic beverage sales tax and pari-mutuels sales tax

- Current charges: "Amounts received from the public for performance of specific services which benefit the person charged and from sale of commodities or services other than utilities and liquor stores." ("Current charges" as defined by the Census Bureau correspond to user fees or user charges.)

Examples: Sales of postage by the U.S. Postal Service; fees from turnpikes, toll roads, ferries, bridges and public parking facilities; sale of defense materials to non-federal sources; airport hangar rentals; and tuition and other expenses at public institutions of higher education.

- Miscellaneous revenue: "Miscellaneous general revenues which do not fall into one of the above Tax, Intergovernmental Revenue, or Current Charges categories."

Examples: Interest earnings, donations from private sources, proceeds from sale of land and improvements associated with housing and community development programs, rental of unused land or property, timberland leases and net lottery revenue.

DIFFICULTIES IN DISTINGUISHING DIFFERENT TYPES OF GOVERNMENT REVENUE

It is widely recognized that the lines between these categories are sometimes blurred: "Courts in many states have tried to create a clear distinction between taxes and fees. This is a very difficult task, however, and the result has been a lack of consistency among the states about the legal distinction between taxes and fees."⁵² There are three questions state courts often ask when making distinctions between taxes and fees.⁵³ First, is the fee or tax levied by the department of revenue or by a regula-

tory authority? If the state revenue department has the authority, and the legislation originated in a tax-writing committee, it is more likely to be considered a tax. In the case of lotteries, some agencies are independent but many others are part of a revenue, finance or treasury department. Lottery bills have originated in many different legislative committees in different states, including Ways and Means, Appropriations, Travel and Tourism, Labor and Commerce, and Education.

The second consideration is the intent of the governing body: "Is the purpose and intent of the fee or tax to raise revenues to benefit the community at large, or is it to meet the infrastructure and other needs of the fee or tax payer?"⁵⁴ If it is the latter, it is more likely to be considered a fee than a tax. The lottery, however, falls into the former category since lottery revenue is used to fund projects that benefit the community at large.

Third, how are the funds used? Are they put into the general fund or into a special fund that covers regulatory or other costs of providing the good or service in question? If the amount of revenue generated is more than the amount needed to provide the good or service, and if the revenue is used to fund unrelated government activities, courts are likely to consider it a tax rather than a fee. This is certainly the case with lotteries. Operating costs (including vendor commissions) in Fiscal Year 2003 accounted for only 27 percent of the takeout from traditional (non-VLT) lottery games; the rest was kept by state governments as "profit"—really tax revenue—and used to fund projects that were, for the most part, entirely unrelated to lotteries.

This use of revenue from taxes and fees is important not just from a tax policy standpoint, but also in terms of administrative accountability: "If user charges exceed the cost of providing services, or if separate accounting is not used, governments are vulnerable to court rulings that such charges are taxes. Taxes are subject to much stricter court scrutiny. ... Also, a court ruling that a fee is really a tax may subject it to voter approval or supermajority requirements imposed on tax increases in some states."⁵⁵ This may partly explain why legislators are reluctant to call lottery "profit" a tax. The National Conference of State Legislatures issues guidelines for user charges, including "User charges should cover the cost of the services provided. They should

⁵² National Conference of State Legislatures, "The Appropriate Role of User Charges in State and Local Finance," (July 1999), 3.

⁵³ Ibid.

⁵⁴ Ibid.

⁵⁵ Ibid., 13.

not be used to generate excess revenues that are diverted to unrelated programs or services.”⁵⁶ The Office of Management and Budget describes a similar guideline for federal user charges: “[U]ser charges will be sufficient to recover the full cost to the Federal Government ... of providing the service, resource, or good when the Government is acting in its capacity as sovereign.”⁵⁷ A state government acts in its capacity as sovereign when it has a monopoly on lottery provision, but it clearly recovers more than the cost of providing the good.

Clearly, as the answers to the above questions indicate, the lottery is not a type of user fee. But that still does not necessarily rule out the possibility that “miscellaneous revenue” is the most appropriate classification. However, the other items that the Census Bureau classifies as “miscellaneous revenue” (see list above for examples) do not have much in common with the lottery; they do not involve the sale of a good or service on which the government has a monopoly, with proceeds going to fund other programs.

Items listed in the category of “Utility and Liquor Store Revenue” are somewhat similar to the lottery. These items are all fees for utilities, with the exception of state-run liquor store revenue. In the case of utilities like water and electricity, there are reasons governments, rather than private vendors, provide these services. Alcohol, on the other hand, does not need to be sold by the government. Lottery and alcohol revenue (in Alcoholic Beverage Control states) therefore should be considered implicit taxes. There is no reason to put the lottery—or alcohol—in a miscellaneous catch-all category if it would fit better in a more clearly defined category. Of course state revenue departments do not consider taxes to be implicit or explicit; they consider revenue to be simply tax or non-tax. But “implicit tax” would be the most accurate description for lottery “profits” (and for profit collected in state-run liquor stores).

VISIBILITY

The Census Bureau states that in order to be considered a tax, a transfer of money must be visible to the consumer as a tax (the “visibility test”).⁵⁸ However, excise taxes are not always visible as taxes to the average consumer; a liquor store receipt does not itemize all federal, state and local taxes included in the price. This lack of visibility does not prevent

an alcohol excise tax from being considered a tax, and it should not prevent the lottery from being considered a tax. Lottery taxes may actually be more apparent to the consumer than alcohol taxes, simply because of all the advertising lotteries receive, paid and unpaid. Ads often mention that the lottery is raising money for education, so consumers may be aware that a portion of their ticket price is being kept by the government, ostensibly for public education. However, they are most likely not aware of the amount.

IMPLICIT LOTTERY TAXES ARE ANALOGOUS TO ALCOHOL EXCISE TAX IN ABC STATES

An analogy can be drawn between lottery states and Alcoholic Beverage Control (ABC) states, in which the sale of alcohol is limited to and regulated by the government. No private vendors are allowed to sell or distribute alcohol in these 18 states (and one county). The other states are “license states,” where private vendors sell alcohol with a license from the state. In the ABC states, the government raises revenue from the operation of the stores as well as from excise taxes (the operating income and excise taxes are considered two separate categories of revenue). In fact, in Maine there is a Bureau of Alcoholic Beverages and Lottery. While it oversees each product separately, it also reports total sales for both products combined.

With both lottery tickets and alcohol, the consumer purchases a product from the government and pays a price above and beyond what it costs the government to provide the product, with the “profit” going to the state—“profit” meaning, for the lottery, the money that is left after prizes and operating costs have been subtracted and, in the case of alcohol sales, the money that is left after operating costs have been accounted for. In both cases the government legalized a previously illegal product, granted itself a monopoly on the sale of that product and collects revenue from the sale of the product. A private vendor could easily sell lottery tickets and, in many states, private vendors do sell alcohol (with a license from the state). With both lotteries and alcohol in control states, the government has granted itself a monopoly on the sale of a product that does not need to be sold by the government. There is nothing inherent in the sale of lottery tickets—or

⁵⁶ Ibid.

⁵⁷ Office of Management and Budget, “Circular No. A-25, Revised,” 3.

⁵⁸ U.S. Census Bureau, *Government Finance and Employment Classification Manual*, 7.21.

alcohol—that mandates it be sold exclusively by the government and taxed heavily, with “profits” going to unrelated programs. The only use of lottery proceeds that is even tangentially related to the sale of lottery products are programs to prevent and treat gambling addiction, which are run by some states.

Because the government has a monopoly on both products, the total price can be set at whatever amount the state chooses, and the rate can easily be raised or lowered to raise revenue or discourage consumption. In the case of lotteries, the takeout rates are increased mainly to raise revenue since the state does not want to discourage lottery consumption, although excise taxes on other forms of gambling could in theory be raised to discourage gambling. If the rationale of the heavy implicit lottery tax were simply to discourage use (as is sometimes said to be the case with tobacco), then the government would not advertise the lottery. Many people would have serious reservations about government-run ads for cigarettes or alcohol, but lottery ads abound on TV, on the radio and in print.

The National Gambling Impact Study Commission, in its final report, recognized the similarity between lotteries and products like alcohol and tobacco when it correctly referred to the lottery as a “sin tax.”⁵⁹

STATES COULD MAKE IMPLICIT LOTTERY TAXES EXPLICIT

The Census Bureau publishes a chart titled “Gross Revenue from Pari-Mutual and Amusement Taxes and Lotteries,” in which lottery revenues are reported alongside tax revenues collected from enterprises such as state racetracks. From a revenue standpoint, the lottery is no different from the pari-mutual taxes; once the money is in state coffers, it can be directed to a particular program or to the general fund. Lotteries could be run privately and taxed by state governments the same way casinos and pari-mutuels are, or they could be run by the state and taxed explicitly—and more honestly. In both cases the taxes would be excise taxes, like those on alcohol. Other forms of legal gambling are already taxed at the federal, state and local levels. In 2003, commercial casinos paid more than \$4 billion in tax revenue to state and local governments, including taxes on profits, admissions, amount wagered and equipment.⁶⁰ Pari-mutuels are also subject to a variety of taxes.

There are several reasons legislators and lottery officials would rather not label the lottery a tax. It would be politically unpopular; a legislator who wants to create a state lottery, add a new product to an already existing lottery or raise the percentage of sales that goes to the state would be “raising taxes” rather than “raising money for education.” Changing the distribution of revenue would also be more complicated. Lottery agencies would also be subject to greater government oversight and scrutiny. Lottery officials and pro-lottery legislators have a vested interest in maintaining the current system and, because they have a monopoly on lottery provision, they’re able to. They do not make explicit the nature of the lottery tax because, quite simply, they do not have to.

Implicit Tax Rate on Lotteries

It is possible to calculate the implicit tax rate on lotteries and compare it to other taxes. The first way to do this is to simply consider how much of every dollar spent is kept by the government. In Fiscal Year 2003, 31.1 percent, or 31 cents, of every dollar spent on lottery tickets was kept—as “profit,” not to cover administrative costs or retailer commissions—by state governments. (This does not take into account federal and state income tax on winnings.) Another way to look at the rate is as a percentage of the net-of-tax price,⁶¹ which is the portion of the purchase price that is returned to the players in the form of prizes and the portion that covers operating costs. The net-of-tax price in FY 2003 was \$30,961.9 million and the tax was \$13,990.6 million so the tax rate was 45.2 percent (13,990.6/30,961.9). (See Table 3.)

The state with the highest implicit lottery tax rate as a percentage of net-of-tax price is Oregon (83.3 percent) followed by West Virginia (61.3 percent). (Different reporting methods for VLT sales in these states mean these rates are not strictly comparable.) The third highest is Pennsylvania (58.6 percent) (no VLTs), followed by California (58.5 percent). The lowest rates can be found in South Dakota (20.9 percent), Rhode Island (23.1 percent), and Vermont (25.6 percent). (South Dakota and Rhode Island have VLTs.) The average lottery state has an implicit tax rate of 42.4 percent.

Taking into account only states that have lottery

⁵⁹ National Gambling Impact Study Commission Final Report (Washington, DC: Government Printing Office, 1999), ch.2, p. 3.

⁶⁰ American Gaming Association, “Tax Contributions,” available at http://www.americangaming.org/Industry/factsheets/statistics_detail.cfv?id=10

⁶¹ Clotfelter and Cook, *Selling Hope*, 232.

ies, the U.S. per capita lottery tax burden in Fiscal Year 2003 was \$55.07.

Arguments Against State-Run Lotteries

Despite the widespread acceptance of lotteries throughout most of the country, they present serious problems.

TAX POLICY CONCERNS

While there is still some moral opposition to state lotteries, and concern about potential social consequences (such as gambling addiction), tax policy concerns cannot be overlooked. State-run lotteries are examples of poor tax policy, for a number of reasons.

Regressivity

An important consideration with any tax is whether it is regressive—that is, whether low-income people bear a disproportionately high tax burden. Although there have been some studies to determine whether this is true of lotteries,⁶² many other studies focus simply on rates of participation—how many people in each income bracket play the lottery and how often—which is not a true measure of regressivity since it does not take into account the amount spent. Some studies have shown that lottery spending is higher in low-income zip codes.⁶³ These correlations are useful but not entirely reliable, since people often buy lottery tickets outside their own neighborhoods. Many people buy them near their place of work, and many buy tickets in neighboring states either because their own states do not offer lotteries or to take advantage of a high jackpot.

The National Gambling Impact Study Commission (NGISC), which was created by Congress in 1996 to “conduct a comprehensive legal and factual study of the social and economic impacts of gambling,” commissioned a study to determine whether lotteries were regressive and concluded that they were: “Lotteries, in fact, are highly

regressive sources of income. Players with household incomes under \$10,000 bet nearly three times as much on lotteries as those with incomes over \$50,000.”⁶⁴ The NGISC found that in 1997, 20 percent of players accounted for 82 percent of sales.⁶⁵ They also found that, although people across the income spectrum played the lottery frequently, those with household incomes under \$25,000 played the least (48.5 percent for those with incomes under \$10,000 and 46.7 percent for those with incomes between \$10,000 and \$24,999). The group with the highest participation rate (61.2 percent) was the \$50,000 to \$99,999 bracket. Overall, 51.5 percent of those surveyed reported playing the lottery at least once in the previous year.⁶⁶

However, frequency of play is not what determines regressivity; the amount of money spent is the more important factor. The NGISC found that not only did the poorest participants spend a higher percentage of their incomes on the lottery; they also spent more as a dollar amount. Those with household incomes under \$10,000 spent more per capita (\$597) than those with incomes from \$10,000 to \$24,999 (\$569) and considerably more than those with incomes of \$25,000 to \$49,999 (\$382), \$50,000 to \$99,999 (\$225) and over \$100,000 (\$196). Furthermore, those with the least education spent the most, although they did not play more often.

Studies on the lottery’s regressivity do not all agree as to the exact amounts or percentages of income spent, but there is a consensus among most lottery researchers that state lotteries are regressive. One study even found a positive albeit small relationship between unemployment rates and lottery ticket sales. Between 1983 and 1991, when unemployment rates went up, lottery sales increased slightly, suggesting that perhaps some people see the lottery as a solution to financial hardship and spend money on it when they can least afford it.⁶⁷

It has also been argued that earmarking proceeds for college scholarships—if it actually increases the available scholarship funds—results in the transfer of money from low-income players to the middle-class students who most often qualify for college scholar-

⁶² See, for example: National Gambling Impact Study Commission Final Report, ch.7; Clotfelter and Cook, *Selling Hope*, 222-230; Mary O. Borg and Paul M. Mason, “The Budgetary Incidence of a Lottery to Support Education” *National Tax Journal* 41 (March, 1988): 75-85; Clotfelter and Cook, “State Lotteries,” 12; Cornwell and Mustard, 2-3; Virginia Lottery, “Who Plays the Lottery,” (1997), quoted in Charles T. Clotfelter, “Do Lotteries Hurt the Poor? Well, Yes and No,” *Duke Policy News* (Summer 2000) (summary of testimony given to North Carolina House Select Committee on a State Lottery, April 19, 2000).

⁶³ See, for example: Craig Whitlock, “Lottery Sales Highest Among the Poor,” *Washington Post*, October 23, 2003, p. PG06; and Leah Samuel, “The Poor Play More,” *The Chicago Reporter*, October 2002.

⁶⁴ National Gambling Impact Study Commission Final Report, Executive Summary, 14.

⁶⁵ Clotfelter and Cook, “State Lotteries,” 12.

⁶⁶ Clotfelter and Cook, “State Lotteries,” 31.

ships.⁶⁸ This alleged transfer does not, however, increase the actual regressivity of the implicit tax itself, as some critics have suggested, since the regressivity of a tax is not determined by the distribution of the revenue. But it may provide critics of lotteries and earmarking with more ammunition.

Lottery proponents counter the regressivity claim by arguing that the lottery is voluntary and that the poor spend a disproportionate amount of their income on other consumer items as well,⁶⁹ but this argument fails to take into account the fact that, unlike other consumer goods, lottery tickets are sold and promoted by the government. Should the government be in the business of selling, marketing and profiting from an item on which the poor spend—albeit voluntarily—a higher percentage of their income (or even a higher dollar amount) than do the middle class and the wealthy?

Economic Neutrality

From a tax policy standpoint, the main concern with lotteries is that they are not economically neutral. One principle of sound tax policy is that the tax system should be neutral, not favoring the consumption of one good over another. Taxes should not distort consumer spending. Other types of commercial gambling are taxed, but the high government “profit” rate on lotteries makes the payout rate (percentage of spending returned as prizes) lower than in other forms of gambling. So lotteries are singled out for a higher tax rate than other forms of gambling, just as alcohol is singled out among beverages for a high excise tax rate, with certain types of alcohol taxed more heavily than others. This not only distorts economic activity; it may also encourage tax evasion and trafficking in numbers running and other illegal gambling.

Dwight R. Lee, Ph.D. discussed the inherent regressivity of excise taxes in *Tax Foundation Background Paper No. 19*, “The Use and Abuse of Excise Taxes”:

Excise taxes are conspicuously at odds with the goal of reducing tax distortions; they are the most distorting of all taxes per dollar raised. Instead of spreading the tax burden as neutrally as possible over a broad tax base,

excise taxes single out a few products for a high and discriminatory tax burden that motivates consumers to avoid that burden by shifting away from products that provide them with the greatest value per unit of product cost. (p. 4–5)

(For further discussion of excise taxes, see two issues in the *Tax Foundation Background Paper* series; No.18, “Excise Taxes and Sound Tax Policy” and No.22, “The Regressivity of Sin Taxes.”)

Transparency

Another principle of sound tax policy is that the tax system should be as simple and clear as possible. Taxpayers should understand what is being taxed and what the tax rates are. The implicit nature of the lottery tax, however, makes it hard for lottery players to know the amount of tax they are paying. This information is available from state lottery agencies, but lottery retailers do not give customers receipts at the time of purchase that list the percentage of the ticket price going to the state government. It is easy for the tax to be disguised, raised or lowered without taxpayers’ knowledge.

Lottery agencies can raise or lower the lottery tax in numerous ways: by introducing new games, by changing the percentage of the sale price that ends up in state coffers, by increasing the ticket price, or by introducing an entirely new type of product, like VLTs, with a different payout rate than previous types of games. They can make many of these changes without legislation. Prices are set based on the amount of revenue needed, not on a market price for lottery tickets (since they are not sold by private vendors), so there is incentive for frequent changes—generally increases—in the lottery tax rate, which decreases transparency and government accountability.

LOTTERY AGENCIES ARE NOT BOUND BY THE SAME LAWS AS OTHER GOVERNMENT AGENCIES

Another argument against state-run lotteries centers on the design of their agencies. States differ in the administrative rules their lottery

⁶⁷ John L. Mikesell, “State Lottery Sales and Economic Activity,” *National Tax Journal* XLV11 (March 1994), 165-171.

⁶⁸ See, for example, Christopher Cornwell and David B. Mustard, “The Distributional Impacts of Lottery-Funded Aid: Evidence from Georgia’s Hope Scholarship,” unpublished paper, University of Georgia (2001).

⁶⁹ North American Association of State and Provincial Lotteries web site: <http://www.naspl.org/faq.html#whoplays>.

agencies must follow. Some agencies are part of a department of state government, usually the department of revenue. However, the majority of states have established separate agencies, which do not have to abide by all of the rules that govern other state agencies. In a few states, the lottery agency is independent and only quasi-public.

It is argued that this independence is necessary in order for the lottery to operate as a business and generate as much revenue as possible. This includes, in a few states, paying managers salaries comparable to those in the private sector but not generally allowed for government employees. (The nascent Tennessee Lottery has recently been criticized for paying its CEO \$350,000 with the possibility of bonuses, contingent upon sales, that could bring the total salary to \$752,500—more than the governor makes.)⁷⁰ This raises the question of whether the goal of raising as much revenue as possible is compatible with the goals of responsible government.

In 2003 the Iowa Lottery Division switched from a state-agency model, under the Department of Revenue and Finance, to a business model and became the Iowa Lottery Authority. If the switch proves profitable, others might follow suit. Connecticut is the only other state to make this change, although many of the newer lotteries have been organized as corporate-model entities from their inception.

ADVERTISING

The operation of lotteries is one of the most visible activities of state government.⁷¹ Until 1975, federal law banned lottery advertisements, but today lotteries not only pay for advertising; they also benefit from free advertising when TV stations and newspapers report each day's winning numbers. In 1997, states spent \$400 million on lottery advertising, or 0.9 percent of total sales.⁷² Lottery proponents point out that this percentage is lower than the percentage most industries spend on advertising. Many states place restrictions on lottery advertising, which range from the vague and unenforceable (ads must be "consistent with the integrity and good taste of the state" in Florida, Indiana and Montana) to the specific (the South Dakota Lottery is prohibited from advertising VLTs, and minors can't appear in Kansas lottery ads). Some states have require-

ments about presenting the odds of winning in ads or the ways in which proceeds will be used. A few have bans on ads that are intended primarily to induce people to play; their ads must be strictly informational. However, lottery agencies would not advertise if they did not wish to attract new players or convince existing players to increase their participation. A few states cap advertising expenditures at around 3 percent or 4 percent of their budget.

The important question is whether the government should encourage people to play the lottery at all. It is, after all, an activity that was banned for 70 years and considered to be a cause of crime, potential addiction and large financial losses. Some states devote part of the proceeds to programs for gambling addiction, which shows that they are aware of the potential problems. State lotteries are unique among government agencies in that they actively encourage participation in an activity that they prohibited only 40 years ago—an activity from which they now profit. Even ABC states do not advertise the sale of alcohol.

Arguments Raised in Favor of State-Run Lotteries

There are many arguments on both sides of the lottery debate, having more to do with social and political concerns than tax policy concerns.

DO STATE-RUN LOTTERIES REDUCE ILLEGAL GAMBLING?

One such argument made by lottery proponents is that legal lotteries reduce illegal gambling. Since it is difficult to measure revenue from an illegal activity, estimates of the prevalence of and revenue generated by illegal gambling are problematic and vary widely.⁷³ A 1983 IRS report based on a federally funded study estimated illegal gambling revenue at \$3 billion just four years after it had published figures more than three times that high.⁷⁴ Illegal gambling, whether sports betting, internet betting or numbers running, is often measured with a formula that—perhaps incorrectly—assumes illegal gambling revenue to rise as legal gambling revenue rises. One source estimates that the handle (total amount spent

⁷⁰ Tom Humphrey, "Did lawmakers buy winning ticket in lottery?" *Knoxville News-Sentinel*, November 2, 2003, on http://www.knoxnews.com/kns/opinion_columnists/article/0,1406,KNS_364_2390247,00.html.

⁷¹ Clotfelter and Cook, "State Lotteries," 19.

⁷² *Ibid.*, 8.

⁷³ See, for example, Eugene Martin Christiansen, "The 1986 Gross Annual Wager," *Gaming and Wagering Business* 6 (July 1987), 14, quoted in Clotfelter and Cook, *Selling Hope*, 20; Commission on the Review of the National Policy toward Gambling, *Gambling in America*, 64, quoted in Clotfelter and Cook, *Selling Hope*, 19--20.

plus prizes) for illegal numbers games in 1974 was 1.1 billion, and \$5.5 billion in 1986.⁷⁵ If these estimates are accurate, then it does not appear that the growth spurt of state lotteries in the early 1980s reduced participation in illegal numbers games. It has been estimated that between \$80 billion and \$380 billion—a wide range—is wagered on sporting events in the U.S. each year,⁷⁶ and internet gambling is growing quickly, with estimated 2003 global revenues of \$5 billion.⁷⁷

It's difficult to speculate on the effect lotteries and other legal gambling have on illegal gambling. Illegal gambling, including lotteries, still flourishes. When state lotteries introduced numbers games in the 1970s, they rationalized them with the claim they it would reduce participation in illegal numbers games. Illegal games persist, however, for several reasons: they are more convenient; retailers are willing to extend credit; the minimum bid is smaller; it is easy to evade taxes on illegal winnings; and some states run computer checks to determine whether winners owe the government money or receive welfare.⁷⁸ (Between April 1997 and April 1998, New York State collected more than \$2.5 million in lottery prize money from parents who owed child support and former welfare recipients, who are expected to partially repay the state.⁷⁹ Also, the federal government can deduct delinquent child support from lottery winnings.) It has been said that illegal numbers games have higher payout rates, but it's not clear that they actually do.⁸⁰ The legal numbers games may have even strengthened the illegal games in two ways: frequent advertising raises awareness of lotteries in general, and legal lotteries provide an easy way for illegal lottery operators to choose and publicize their own winning numbers.⁸¹ On the other hand, anecdotal evidence shows that the legal game may have undercut the illegal game in some regions.⁸²

STATE-RUN LOTTERIES ARE RELATIVELY FREE OF CORRUPTION

Just as there are concerns about crime in illegal gambling, there are also concerns about fraud in the operation of legal lotteries. For the most part, modern state lotteries have been free of corruption, although there have been some notable exceptions. They include a 1981 Pennsylvania numbers game drawing in which some of the Ping-Pong balls were injected with fluid so they would not rise to the top and would not be selected. In 1975 the New York lottery was temporarily shut down by the governor when it was discovered that lottery operators had announced the numbers of winning tickets that they knew had not been sold. Lottery agencies appear to go to great lengths to ensure honesty and accountability. State lottery web sites generally list the odds of winning each game, mention responsible play, describe the uses of proceeds, publicize the names of winners and provide the public with annual reports.

OTHER ARGUMENTS, PRO AND CON

Other arguments against the lottery are that it discourages hard work and saving; gambling is considered by some to be immoral; and it can cause gambling addictions. There is scant evidence for this last claim; however, as technology allows lottery agencies to offer more new products that involve fast play, immediate results and casino-style games, addiction might become more of a concern. Arguments in favor of the lottery—other than the revenue generated for government programs—are that lotteries are, for many people, entertaining and enjoyable; it is better to raise revenue from a voluntarily-purchased product than to raise taxes; people will gamble whether it is legal or not; and there is less chance of corruption from a state-run lottery and less benefit to organized crime.

⁷⁴ *Estimate of Income Unreported on Individual Income Tax Returns*, Publication 1104 (9-79) (Washington, D.C.: Internal Revenue Service, 1979); and U.S. Department of the Treasury, Internal Service, Office of the Assistant Commissioner (Planning, Finance and Research), Research Division, *Income Tax Compliance Research: Estimates for 1973—1981* (Washington, D.C., July 1983), both quoted in Clotfelter and Cook, *Selling Hope*, 131.

⁷⁵ Eugene Martin Christiansen, "1986 Gross Annual Wager," 14, quoted in Clotfelter and Cook, *Selling Hope*, 20.

⁷⁶ Robert Macy, "Ban on College Sports Betting Could Cost State Books Millions," *Las Vegas Review-Journal* (May 18, 1999), 4A, quoted in National Gambling Impact Study Commission Final Report, ch. 2, 14..

⁷⁷ United States General Accounting Office "Internet Gambling: An Overview of the Issues," December 2002, 5.

⁷⁸ Clotfelter and Cook, *Selling Hope*, 132.

⁷⁹ New York State Office of the Governor, "Governor Pataki: Lottery Recoups Prize Money from Deadbeats," (May 5, 1998), available at http://www.state.ny.us/governor/press/may5_98.html.

⁸⁰ Clotfelter and Cook, *Selling Hope*, 19.

⁸¹ *Ibid.*, 132.

⁸² *Ibid.*, 133.

Options

There are other options for the operation of lotteries, although state governments will probably not consider them anytime soon. Charles T. Clotfelter and Philip J. Cook have described three possible models for lotteries.⁸³ One alternative is a sumptuary lottery, which would provide lottery games only in order to regulate them while discouraging consumption. There would be a high tax rate—a “sin tax,” similar to the current tax on tobacco. The second model is the consumer lottery, which would raise the payout rate in an attempt to provide a desired product to informed customers, operating under the assumption that the consumer knows best what he wants. Neither of these models would be concerned with raising revenue for the state. They would both utilize user fees rather than taxes. The third option, the revenue lottery, describes lotteries currently in operation. A revenue lottery seeks to increase government revenue and therefore has a low payout rate.

What Does the Future Hold for State-Run Lotteries?

In 1999 the National Gambling Impact Study Commission recommended a moratorium on the expansion of all gambling in the U.S. Clearly its advice has not been heeded. Battles over lottery enactment and expansion are being waged in a number of states.

MOST NON-LOTTERY STATES ARE CONSIDERING LOTTERIES

For many non-lottery states, it is no longer a question of whether a lottery will be enacted, but a question of when. Legislators and governors stress the supposed need for additional revenue to deal with budget shortfalls and the perceived loss of money to neighboring lottery states. They campaign fervently for lotteries and talk about the noble goals of providing college scholarships and improving the public schools. There is less and less of a stigma to all forms of legalized gambling as they become more commonplace. Twenty years ago, lottery researchers searched for the reasons certain states enacted lotteries. Now, forty years into the modern lottery movement, the question is: Why do certain states not

enact lotteries? What unusual factors prevent lottery enactment in the ten remaining non-lottery states, and will it be just a matter of time before they also have lotteries?

Legislators in states that have recently enacted and expanded lotteries have repeatedly stressed the supposed need for new revenue sources to close budget gaps, but they may be confusing a need for revenue with the desire for additional revenue, and voters, who almost always vote in favor of lotteries, seem to be convinced of the need. Even if lotteries are not truly being approved in response to actual fiscal crises, that is most likely how they are perceived by much of the public.

Will Oklahoma Be Next?

Oklahoma seems poised to become the next lottery state. Oklahomans will decide in November when they vote on two lottery referenda. State Question 705, the Oklahoma Education Lottery Act, authorized by House Bill 1278, will ask voters whether to create a lottery to support public education (including college scholarships) to be overseen by an Oklahoma Lottery Commission. The lottery would exclude any type of video gaming device or other electronic lottery device. State Question 706, authorized by Senate Joint Resolution 22, deals with the intended use of proceeds and will ask Oklahomans whether to create an Oklahoma Education Lottery Trust Fund, “to be expended only for certain education-related purposes; prohibiting the Legislature from using the trust fund to replace other funds supporting education purposes ...”

The proposals have the support of a large coalition of education groups and the Superintendent of Education, and are opposed by conservative and religious organizations. Both sides are conducting expensive grassroots campaigns to sway voters’ opinions. Oklahomans rejected the lottery at the ballot box in 1994, but this does not necessarily spell defeat for the current proposal. North Dakotans rejected lottery proposals at the polls three times before finally approving one. The current proposal seems to have enough support to pass.

Other States May Decide In the Near Future

Arkansas voters rejected a lottery at the polls in 2000, but the proposal was revived by a former gubernatorial candidate as a possible initiative for

⁸³ Clotfelter and Cook, *Selling Hope*, 242.

⁸⁴ Gary D. Robertson, “North Carolina Governor Brings in Georgia Officials to Talk up Lottery,” Associated Press, July 4, 2001, quoted on <http://www.lotteryinsider.com/lottery/ntcarol.htm>.

the November ballot. The proposal faced a number of hurdles, including rejection by the attorney general's office several times for names and titles that did not accurately describe the initiative's content. The proposal would allow the legislature to vote on a lottery and would also legalize other types of gambling in liquor-license establishments. Lottery proposals are nothing new in Arkansas. In addition to the ill-fated 2000 proposal, a 2003 proposed constitutional amendment that would have allowed a lottery failed to make it through the state legislature. Although Arkansas already allows greyhound and horse racing, gambling proposals have generally not fared well in Arkansas and are often halted by legal challenges, the attorney general's office, or voters at the ballot box. In 1996 a measure that would have outlawed all gambling in the state was defeated, but at the same time voters and legislators do not seem quite ready to legalize lotteries, especially when lottery proposals are tied to proposals for other types of gambling. However, legislators are concerned with finding additional public school funding and will most likely raise the lottery issue again in the near future.

In Alabama a 1999 referendum to remove a constitutional ban on lotteries failed at the polls. The proposed lottery, which was modeled on Georgia's lottery, was intended to provide college scholarships. The legislation was reintroduced earlier this year in the House Tourism and Travel Committee but has been postponed indefinitely.

In North Carolina a lottery referendum narrowly missed a spot on the 2002 ballot when, less than two months before the election, legislators defeated the proposal. The bill had the strong support of the governor, who is currently running for re-election and has made a lottery for education one of his campaign issues. The 2003-2004 General Assembly considered two lottery proposals: the 2003 Education Lottery Referendum and the Local Option Education lottery, which would give counties the option to participate in a state-run lottery and receive part of the proceeds for public schools. No action has been taken on the bills and it does not appear that a lottery referendum will be on the ballot this year. However, it may be just a matter of time before North Carolina starts a lottery, since the issue has been a topic of debate for quite a while. In a 2001 speech Governor Mike Easley proclaimed, "It's either going to have to be lottery, a lottery for education, or it's going to have to be a tax."⁸⁴

In Mississippi, a lottery bill (House Bill 1064) died in committee in March. In 1992, Mississippi voters took the first step toward lottery enactment by removing a constitutional ban, but the following year

lawmakers refused to create a lottery, citing a lack of widespread support throughout the state and a likely veto by the governor. Since then there has been a rapid expansion in other types of gambling in the state, but little sustained interest in creating a lottery.

In Wyoming a lottery bill passed the House this spring but did not make it through the Senate. The bill's sponsor has vowed to reintroduce it next year. The bill would have allowed Wyoming to join Powerball, a multi-state lottery, but not to create a lottery of its own. This is the model used by North Dakota.

Alaska considered lottery proposals last year in both the House and the Senate but, as in previous years, did not act on them. The House bill would have created a lottery commission under the Department of Revenue and the Senate bill would have established a quasi-governmental lottery corporation.

In Nevada lottery bills were considered in 2001 and 2003 and a bill draft request has been submitted for the 2005 session. The bill draft would establish a lottery to help pay senior citizens' property taxes. If this bill—or any other—passes, a referendum will be necessary to remove a constitutional ban. The Governor's Task Force on Tax Policy has expressed support for a lottery, but there is concern among the casino industry that a lottery would present competition.

In the 2003 and 2004 legislative sessions, Hawaii considered a bill on a referendum to legalize gambling. The state has no standard initiative or referendum process, but the issue could be put before the voters as a constitutional amendment. A former governor proposed a lottery to fund education and deal with a budget shortfall, but the proposal was not widely supported in the legislature and it does not appear that a gambling referendum will be on the ballot this year. The referendum, if approved, would have asked voters in the November 2004 election two separate questions: should gambling be legalized in Hawaii and, if so, what kind? Voters would have decided on four types of gambling: a state lottery, pari-mutual racing, shipboard gaming and casino gaming. Separate bills were also considered for shipboard and casino gaming.

Utah is not seriously considering lottery proposals and is so far the only state not to succumb to the lure of lotteries.

MANY LOTTERY STATES ARE CONSIDERING EXPANSION

Many state legislatures are expanding or considering expansion of current lotteries, ostensibly to deal

with budget woes. Maine recently joined the multi-state game of Powerball, leaving California and Florida as the only two states not to participate in a multi-state lotto game. Several states already participate in more than one multi-state game and it is likely that others will follow suit.

In March the Georgia House of Representatives passed a bill that would have allowed Georgia to become the first state to sell lottery tickets on the internet. The bill did not pass the Senate but if it had, it would have authorized the Georgia lottery to create individual online accounts that would allow customers to purchase tickets on the internet, with a \$5 per day limit on purchases made with credit cards.

Proposals for VLTs and non-lottery video gaming devices have been especially popular recently. In 2003, 19 states considered bills or proposals to start or increase video gaming devices at racetracks (not all of them related to the lottery).⁸⁵ In Colorado a proposal for VLTs at racetracks was soundly defeated at the polls last November, with 81 percent of respondents voting against it. The campaign leading up to the vote cost more money than any other ballot initiative in Colorado history.⁸⁶ In Texas earlier this year legislators failed in their attempt to add a VLT proposal to a school finance bill. The proposed constitutional amendment would have allowed up to 40,000 video lottery terminals at seven existing tracks. The House instead passed a bill to raise the state sales tax to aid education, but the bill did not become law. It is likely the VLT issue will be raised again.

In Maine a VLT proposal met with more success last year, when voters approved VLTs at racetracks. Maine will soon become the next state to add VLTs, with plans underway for the state's first racino, which will house 1,500 slot machines. However, there is a controversy over how the machines will be regulated. The state lottery agency was originally intended to be involved, but the legislature is instead considering creating a new gaming commission.

In the November 2004 election, voters in Washington State will vote on a ballot initiative that would allow electronic scratch ticket machines at charities, restaurants, taverns, bowling allies, tracks and card rooms. The lottery commission would regulate the machines and proceeds would allegedly be used to lower property taxes.

Voters in the District of Columbia narrowly missed the chance to legalize VLTs this November. Supporters of the controversial Lottery Expansion Initiative Act of 2004 conducted a petition drive, only to have the Board of Elections and Ethics rule that thousands of signatures collected were illegal. The proposal would have authorized a VLT "casino" within a large, privately funded entertainment complex in the northeast part of the city.

In Maryland there was hope that a special last-minute legislative session would finally lead to an agreement on VLTs at racetracks. Heated negotiations collapsed in September but the governor has vowed to bring the issue before the legislature again, most likely in January.

Nebraskans will vote on an unusual amendment in November. It would allocate 10 percent of state lottery proceeds to the Nebraska State Fair Board for operation of the Nebraska State Fair.

In addition to expanding their own lotteries, many states were hoping to have another source of lottery income this year: an international lottery run by the American Multi-State Lottery Association, with members from Europe, Canada, Central America, Australia and the U.S. However, hopes were dashed earlier this year when, after more than two years of planning, European lotteries began to withdraw from the International Lottery Alliance.

A handful of states have recently considered and refused proposals to limit or even end lotteries. The Minnesota legislature earlier this year, in the midst of a legislative audit of the lottery and allegations of possible misconduct, considered abolishing the lottery. They instead settled on a plan for reform and greater accountability. In Kansas the legislature had a chance to abolish the lottery in 2001. The original lottery legislation had a built-in expiration date of 2002, so legislators could have let the lottery come to an end. They instead chose to extend it until 2008. South Dakotans also decided to hold onto their lottery. Voters decided three times to save video lottery in their state—once in a referendum to reauthorize it after the state Supreme Court declared it unconstitutional, and twice to maintain it.

Even smaller anti-lottery measures have not fared well. The Tennessee legislature recently voted against a proposal requiring gambling addiction warning labels on tickets. In Michigan there is a chance this year for a small amount of citizen control over the lottery: there will be a referendum ask-

⁸⁵ Eugene Martin Christiansen, "Status report on U.S. gambling initiatives," ATE On-Line (2004), available at <http://www.ateonline.co.uk/default.asp?showid=14&pageid=1870>.

⁸⁶ Patricia A. McQueen, "Gaming Headlines," *International Gaming and Wagering Business* web site, <http://www.ascendgaming.com/headlines/Archive/WeeklyHeadlines1105.htm>.

ing voters to amend the state constitution to prohibit any new form of gambling that has not been approved by voters. There is some concern that if passed and strictly interpreted, the amendment might prohibit the lottery from introducing new types of games without voter consent. The legislature recently considered a proposal to allow video lottery terminals at racetracks. The fact that the VLT proposal did not make it onto the ballot while the gambling limitation proposal did can be considered a small victory for opponents of state lotteries.

Despite these anti-lottery proposals, no state has yet repealed, through legislation or the ballot box, a lottery or a specific type of lottery product. (Several state Supreme Courts, however, have found specific games unconstitutional.)

Conclusion

No state has abandoned the lottery in the past century and, unfortunately, none is likely to do so soon. Lotteries exemplify poor tax policy, and voters in Oklahoma and other states that do not yet have them would be wise to reject them at the ballot box.

As for lotteries already in operation, given the rate at which they are expanding and raising tax revenue, it is unlikely that states will end them any time soon. If they did, however, they would improve their tax systems by increasing accountability, transparency and economic neutrality, as well as decreasing regressivity. Legislators would find that they do not truly need the tax revenue raised by lotteries; they would either get by without it or raise it through explicit taxation enacted legislatively. They could allow lotteries to continue in the private market or even ban them entirely, but, in either case, the cessation of state-run lotteries would result in more principled state tax systems.

Methodology

Comparisons of state lottery data present some challenges not encountered with other types of state financial data, for the following reasons:

- Lotteries are a relatively new phenomenon and did not start at the same time in every state. There is no uniform system of financial reporting. VLT and VGD sales and profits are not reported the same way in every state or by every organization

that gathers lottery data; sometimes they are not included in state comparisons at all. Some states report charitable gaming revenue as government lottery transfers. The handling and reporting of unclaimed prizes is also not uniform across states.

- Lotteries do not always fit neatly into existing government agencies and not all states have the same amount of government oversight. Some lottery agencies are quasi-government agencies; some are under the department of revenue.
- There are occasional problems with fraud and record keeping. (For example, in 2000 the Pennsylvania lottery's record keeping was found by auditors to be "seriously deficient.")⁸⁷
- Organizations that collect lottery data are not uniform in their collection and reporting procedures. There are differences with regard to what should be considered "profit," "proceeds," "government transfers," "revenue," etc. It can be difficult to reconcile lotteries as a type of gambling with lotteries as an activity of state government; the two methods of financial reporting are not entirely the same. Data from various organizations do not always match entirely, although differences are generally small. Some organizations (such as the North American Association of State and Provincial Lotteries) gather data directly from state lottery agencies; others (Census Bureau) from states' annual financial reports. For this reason, charts in this paper that use different sources may not be strictly comparable.
- Financial reporting is further complicated by many variables: 41 jurisdictions, numerous games in each jurisdiction, varying retailer commissions and bonuses, and frequent changes in products offered. In addition, reporting of sales is done in over 100,000 convenience stores, racetracks and bars.

⁸⁷ Pennsylvania Department of the Auditor General, Lottery Audit, May 2000, available at: <http://www.auditorgen.state.pa.us/Department/Info/Investigations/LotteryRpt.html>

References

The following data sources were used for the tables in this paper:

- *International Gaming and Wagering Business* 25 (June 2004) was used for the lottery revenue/expense analysis (Table 4).
- *The Gross Annual of the United States*, Christiansen Capital Advisors, LLC was used for data on revenue raised by different types of gambling (Figure 3).
- North American Association of State and Provincial Lotteries data was used for total sales and profits, Fiscal Year 2001–2003 (Table 3 and Table 5) and retailer commissions and number of retailers (Table 2).
- *La Fleur's 2003 World Lottery Almanac* was used for cumulative sales, profits and prizes 1964–2002 (Table 1) and *La Fleur's Magazine*, Vol. 11 No. 7 (Sept. 2003) was used for data on sales by type of lottery game (Figure 5).
- North American Association of State and Provincial Lotteries, Bureau of Labor Statistics Consumer Expenditure Survey and the Motion Picture Association of America were used to compare lottery spending to spending on other leisure activities (Figure 4).
- Education spending charts (Table 6 and Table 7) were compiled using data from the U.S. Department of Education, National Center for Education Statistics, Statistics of State School Systems; and Common Core of Data surveys.
- Census Bureau data were used for direct general state/local expenditures in Table 7 and state general own-source revenue in Table 5.

VLT data are included in all charts and calculations unless otherwise noted.

Census Bureau lottery data would have been used more extensively in this paper, but at the time of this writing they were undergoing a revision.



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