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Lotteries: Entering the Big Time In State Finance

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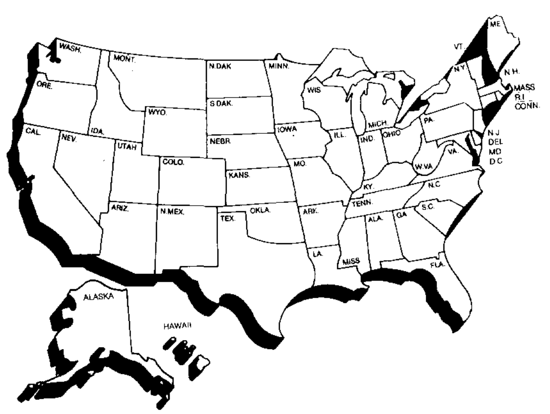
Like it or not — and millions of Americans hate the idea on moral or other grounds — state owned and operated "numbers games" known better as lotteries are a growing part of the financial support for state and local governments in the U.S.

The latest available facts and figures on the increasing financial reach of government-sanctioned gambling are presented in this Tax Foundation Special Report. They show:

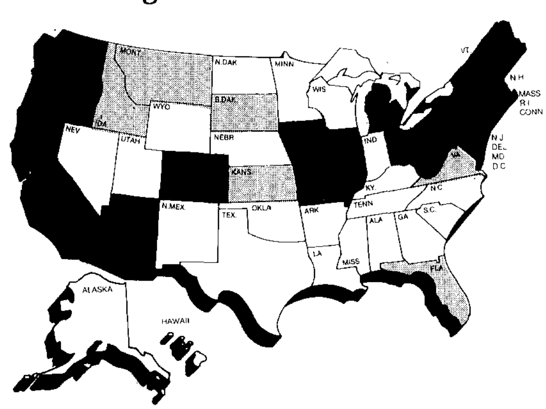
- A total of 22 states and the District of Columbia took in $12.5 billion in lottery sales, producing almost $5 billion in net lottery income, after expenses and prizes, in the fiscal year ended June 30, 1986. Net lottery income for all states has been growing at 29% per year since FY 1980, accelerating to 36% per year since FY 1984. Five additional states approved lotteries in fiscal year 1987. Virginia voters approved a lottery on November 3 and several other states are considering proposals. About three-fourths of the U.S. population now is exposed to state-operated games.
- Lotteries still are a small share of states' total income and charges — 1 to 5 percent of the revenue from state taxes and charges in FY '86 — and profits vary far more, and more unpredictably, than tax revenues. But lotteries' input, and thus their clout at state capitals, is growing. Lotteries brought in more revenue than tobacco and alcohol sales taxes last year in California, New York and eight other states and D.C.
- State lotteries also remain a small part of the gambling financial scene, in terms of dollars. Guesses about the total value of gaming and wagering vary wildly, especially as to the extent of illegal betting in its many forms. One educated guesstimate puts the total "handle" at $199 billion in 1986. In terms of people taking part — a crucial measure

Lotteries Spread, coast to coast —

In 1963 one state, New Hampshire, authorized the first modern state lottery.



Now, in 1987, 22 states and the District of Columbia operate lotteries and 6 others are starting them. Other states are debating the issue.



Lotteries' Rise in the gambling world —

State-owned and operated lotteries have become the fastest growing form of public betting in the U.S. Lottery ticket sales have quadrupled in the last five years, reaching $12.5 billion in the year ended June 30, 1986. But this apparently is only a fraction of the total gambling "handle" (the estimated aggregate sum of all money changing hands in public wagering). Casino table games and slot machines licensed by various states remain the King Kongs of gambling. See the chart on the next page for a perspective on that part of the story.

Map data from "1987 U.S. Gaming Industry" report by Laventhol & Horwath, CPAs.

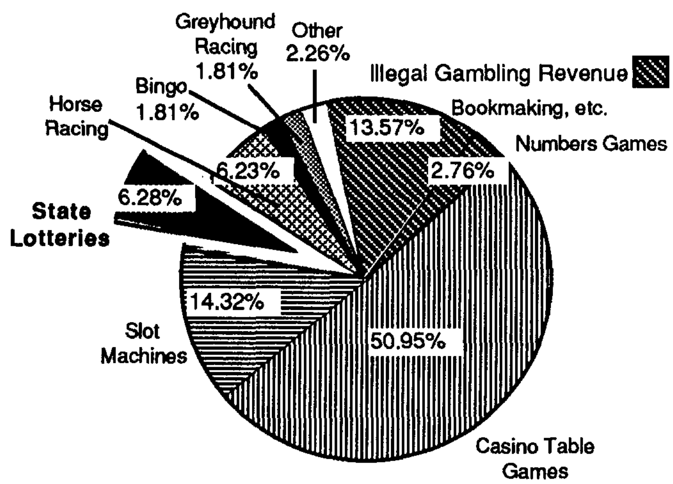
One Measure of the Gambling Industry

No recent official estimates of gambling finances in the U.S. have been published. A presidential commission on law enforcement estimated illegal gambling at $20 billion a year in 1967, and in 1974 the U.S. Department of Justice put the illegal total at $29 to $39 billion. An unofficial estimate of all gambling action is published annually by Gaming & Wagering Business, a monthly magazine. From its latest study, in the July 1987 issue, by Eugene Martin Christiansen, an economist and Special Assistant to the New York City Off-Track Betting Corp. —

> "Aggregate gambling in American commercial games reached $199 billion in 1986; a $7.9 billion, 4.2 percent increase over 1985. The number is an all-time high. It is also partly illusory. More than half that $199 billion was the ebb and flow of chips across casino tables; high-velocity gambling that makes the churn of dollars through parimutuel machines slow and lotto games glacial in comparison. Another $25.2 billion were not physical dollars at all, but credits and debits in telephone transactions between American sports and racing fans and the operators of illegal books. Most of the residue, though, some $72 billion, was real currency and coins, handled through track and OTB (Off-Track Betting) totalizers, slot machines, lottery agencies, bingo halls and the Las Vegas Night craps game at local churches and synagogues. That wad of cash made gambling a major component of the U.S. leisure economy . . ."

Gambling Dollars, Fiscal Year 1986

	$Billions	% of Total
Total "Handle"	199.0	100.00
Legal gambling	166.5	83.67
Casino table games	101.4	50.95
Slot machines	28.5	14.32
State lotteries	12.5	6.28
Horse racing	12.4	6.23
Bingo	3.6	1.81
Greyhound racing	3.6	1.81
Other	4.5	2.26
Illegal gambling	32.5	16.33
Bookmaking, etc.	27.0	13.57
Numbers games	5.5	2.76



Basic Data: Gaming & Wagering Business

of gambling's influence on the economy and politics — state lotteries now are by far the leading form of commercial gambling and the fastest growing.

Latest sign of lotteries' growth came on November 3 when a state game was approved by Virginia, often considered a bellwether for the Old South. That tier of states, except for non-typical Florida, had been the only regional hold-out against lotteries. Another victory for legalized gambling came in Texas, which approved state-sanctioned horse racing and betting for the first time in modern times. With these cracks in the South's front against gambling, the stage is set for a new phase in the hassles over gambling's role in public finances.

Re-play of history. Today's scene is a replay of 19th Century American history, to some extent. Lotteries to raise money for public purposes were common in colonial times. The early Harvard and Yale universities were financed in part with lottery proceeds. The Continental Congress approved a lottery to finance the American Revolution but it failed; the Tories had most of the money.

By the 1830s a number of states had approved various types of lotteries. They generally were state franchises, privately and loosely administered by "lottery contractors" (who included the forerunners of today's Chase Manhattan Bank and Citicorp) and scandals crept into the system. In the aftermath, most states adopted sweeping anti-gambling laws, often embedded in the constitutions of new states. Lotteries, as state-blessed ventures, disappeared.

The Federal government took the stance that gambling was a societal phenomenon and a state responsibility. Enforcement of state laws and local ordinances prohibiting gambling, however, proved to be sporadic and ineffective.

Illegal betting flourished, more or less openly, virtually everywhere. The illegal "numbers" racket, born in New York City's Harlem in the early '20s, proliferated into most big cities, especially after Prohibition ended in 1933 and bootleggers had to find a new field to exploit.

Gambling's Revival. The breakthrough for a return to legalized gambling came in 1931 when Nevada, desperate for revenue after mining's collapse in the Depression, became the first state to legalize casinos offering roulette and other wagering games, with the state government an active partner in supervising operations and sharing in the profits.

Other states in the East and Midwest followed that lead by authorizing similar partnerships in pari-mutuel horse racing (where pools of bettors place their opposing bets, and the track takes a percentage, paying part of that to the state usually in the form of license fees and taxes).

The Federal government got into the action through income taxes on bettors' winnings, plus "occupation" taxes on professional full-time gamblers and slot machines. The latter never produced as much revenue as predicted.

After the troops came home from World War II, wagering grew faster and faster. Illegal gambling became big business, increasingly intertwined with nationwide criminal syndicates and local political corruption. That brought limited Federal intervention in the form of statutes aimed at interstate transmission of gambling information and equipment, mainly useful as leverage against criminals active in drugs, prostitution, "protection" and other mob rackets.

The Lottery Parade. Then, in 1963, the New Hampshire legislature, confronting a state constitutional bar to an income tax, authorized a twice-a-year sweepstakes on horse race results, with the proceeds dedicated to public education. That was the start of the modern fling with state owned and operated lotteries as an integral part of the states' public finances.

New Hampshire's maiden venture was a financial flop at first, and nearly died when neighboring New York began a competing monthly sweepstakes in 1967. The New York operation also failed at first, and was marred by political patronage squabbles which led to its suspension in 1975-76.

But with aggressive marketing and ingenious designs of new games, the early lotteries became financial successes — and politically contagious. In state after state, lottery forces succeeded in getting the issue on statewide election ballots, and usually won by robust margins.

Opponents argued that lotteries are a regressive tax, in effect, bearing hardest on low-income players least able to pay; that lotteries breed gambling fever which creates more compulsive gamblers, fosters a breakdown of public morality and spreads criminal influences in a state's economy and politics. Supporters argued that the public will gamble, one way or another; that voters like lotteries, that participation is voluntary and the money goes for good causes.

Supporters have prevailed, up to now, hitting a peak in 1984 when all four states that had a lottery proposal on the ballot, including California, approved them. North Dakota, however, rejected a lottery in 1986.

Next: Super Jackpots, VDTs. As more states jump into lotteries, competition grows for players and dollars, spurring heightened promotion and marketing drives by lottery agencies, manufacturers of the machines involved, advertising experts, community vendors of tickets.

One major ploy is to increase the size of winnners' prizes as much as possible within the limits imposed by the mandatory level of paybacks to the customers (typically around 50 percent compared with the pari-mutuels' payout rate of around 80 percent), operating costs, and the pressure to meet revenue goals. Lotteries are highly leveraged. After the break-even point, profits are rich. This is leading to multi-state lotteries, which greatly enlarge the pool of players and the potential jackpots for winners.

First was the New England Tri-State game launched in 1985 by Massachusetts, New Hampshire and Vermont. Latest is "Lotto America," announced in Washington September 16. Taking part with the District of Columbia will be

Lotteries as Revenue Raisers
($ in millions)

■ Lotteries' net is small compared with total state revenues. In fiscal year 1986 —

States with Lotteries	Lottery Sales	Net Lottery Income After Prizes, Expenses	Net Lottery Income: As % of All State Taxes (Property, Income, Sales, etc.)	Net Lottery Income: As % of All Own-Source State Revenue†
AZ	121.0	42.3	1.3%	††
CA(1)	1,765.6	692.7	2.2	1.5
CO	111.3	28.4	1.2	††
CT	429.1	190.9	5.0	3.7
DE	40.9	16.7	1.9	1.2
DC	118.7	35.9	2.1	N.A.
IL	1,284.2	540.2	5.5	3.9
IA(2)	81.7	25.9	1.0	††
ME	38.8	11.8	1.0	††
MD	718.3	323.8	6.9	4.8
MA	1,397.9	439.8	5.7	4.8
MI	999.4	415.1	4.4	3.1
MO(3)	81.1	207.0	2.2	4.0
NH	33.8	10.7	2.2	1.0
NJ	900.1	418.2	5.0	3.2
NY	1,317.0	607.9	2.7	1.6
OH	940.0	383.6	4.2	2.6
OR	87.4	26.5	1.4	††
PA	1,320.0	539.2	5.0	3.3
RI	56.9	21.6	2.4	1.3
VT	12.4	3.3	0.1	††
WA	181.2	73.0	1.4	††
WV(4)	53.0	21.0	1.1	††

(1) Lottery began October 1985
(2) Lottery began August 1985
(3) Lottery began January 1986
(4) Results for period of April 1985 (when lottery began) through June 1986
† Excludes Federal grants, "Intergovernmental" transfers
†† Less than 1%

■ Yet lotteries now bring in more revenue than tobacco and alcohol sales taxes in 10 states and the District of Columbia — a trend closely watched by state finance officers who are worried about the future of tobacco/alcohol sales, and prospective declines in the revenues they generate.

Iowa, Kansas, Missouri, Oregon, Rhode Island and West Virginia. The jackpots are expected to reach $10 to $20 million. Promoters hoped California and New York would join, and they may yet. That could bring jackpots up to $80 million or more.

As a lottery's size swells, so do the odds against winning, rising to the tens-of-million-to-1 class, and that might turn off the public. So far the lure of larger prizes seems to enlarge the "play" — and profits.

Another coming idea, already being tried in some places, is lottery games played on video display terminals (VDTs). This provides the elements of player participation and instant payoffs; proven inducements to gamble as shown by the popularity of slot machines ("one armed bandits") and pinball machines.

Eventually, as the interstate connections of lotteries and their suppliers increase, there could be moves in Congress to regulate, if not prohibit, the growing lottery industry. A sizable scandal in lotteries' management, involving prominent politicians and frauds on the public, could touch off that kind of reaction.

"Constant tug of war." The most thorough study of gambling in America, legal and illegal, was three years of investigation and hearings by a commission created by Congress in 1970 anti-crime legislation. In its 1976 final report the Commission made these points:

- "Gambling is inevitable. No matter what is said or done by advocates or opponents of gambling in all its forms, it is an activity that is practiced, or tacitly endorsed, by a substantial majority of Americans . . .
- "Because it is a social issue, the Commission has determined that gambling policy is the proper responsibility of the government entity closest to the lives of citizens— the State . . ."
- "Current gambling policy at the State level accurately reflects the ambivalence and contradiction that have traditionally characterized this nation's approach to the problem of gambling. The States often have found it difficult to formulate reasonable and consistent gambling policy and law. Over the years, two strong, conflicting sentiments have surfaced: That gambling is a morally and socially destructive activity that must be suppressed, and that the enormous popularity of gambling makes it a suitable activity for government to channel into useful and productive ends through licensing and taxation. The history of gambling policy in the United States has been a constant tug of war between these two philosophies, in which each side appears to gain the advantage for a certain period and then begins to lose ground . . ."

A FEDERAL NATIONAL LOTTERY ?

Some members of Congress and high-level officials of the Reagan Administration have cast covetous glances at the money flow generated by state-operated lotteries.

The idea keeps cropping up that maybe a national lottery could bring billions of dollars into a Federal treasury that is deeply in the red. In lottery backers' dreams, the profits would be dedicated to deficit reduction or other worthy goals, such as improved education or medical care for the indigent or homeless housing.

The list of possible uses for any Federal lottery income is long; but the list of open supporters is short, as of autumn, 1987.

In Congress, 5 members of the House have introduced 7 bills (Rep. Cardiss Collins of Illinois made 3 proposals) that if enacted would authorize a national lottery of some type. The House Ways & Means Committee had scheduled no hearings on these bills at the time of this report.

At the Treasury Department, Secretary James Baker reportedly has showed some interest in lottery revenue possibilities. But in its only recent public comment, the Treasury replied negatively to a suggestion that the IRS operate a lottery with tax-exempt prizes, for deficit reduction.

At the White House, members of advisory groups such as the Domestic Council talk, at times, of the dollars a successful 50-state lottery might bring in. But it's just talk so far. The states, it is assumed, would rise up in united wrath if "the Feds" tried to move into the lottery money trough.

In short: National politicians apparently feel they have enough problems without dabbling in gambling. A Department of Army trial balloon for a sweepstakes at overseas posts to benefit Army welfare funds was floated in late '86, and shot down as soon as it ascended to higher, and more politically sensitive, heights. By contrast, the Treasury Department stoutly defends its gambling taxation turf, including income-tax withholding on state lottery winners' prizes above $500, for example.

Note: Sources for this report included "Gambling in America," Final Report of the Commission on the Review of the National Policy Toward Gambling (published by Government Printing Office in 1976, now out of print); "The Business of Ris$k" by Abt, Smith and Christiansen (published by University Press of Kansas in 1985); "Implicit Taxation in Lottery Finance" by Clotfelter and Cook, Working Paper 2246 (published by National Bureau of Economic Research Ins., in 1987).