Options for the Future of Vermont's Lottery

Testimony Before the Ways and Means Committee of the Vermont Legislature

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First, I would like to thank the Committee for inviting me to speak on this topic.

When Governor Douglas proposed leasing the Vermont lottery, he followed a dozen other states that have considered leasing or selling their lotteries. His plan to lease the lottery to private investors for 40 years for an upfront payment of $50 million plus an annual revenue stream has met with significant opposition, as has happened in the other states where this idea has been proposed.

The Tax Foundation believes the best course for Vermont is to sell—not lease—the lottery for a one-time payment, levy sales taxes on lottery tickets, and otherwise remove itself from the lottery business.

We do not believe any state should be in the lottery business, whether it runs the lottery itself or leases it to a private company; the lottery is simply not an appropriate business for the government, no more so than running a casino would be. Running a lottery puts government officials in an awkward position: they must act like CEOs trying to maximize profits while at the same time being mindful of the integrity of the state. We believe these two goals are mutually exclusive. Gambling is an activity many citizens disapprove of, and one that can cause health problems and financial ruin. A full third of Vermonters voted against the referendum that started the lottery. While citizen disapproval certainly does not mean an activity should be prohibited, it does mean that the state should think twice before offering, advertising and profiting from that activity.

Vermont's lottery agency is an independent agency rather than part of another state department. In some states, independent lottery agencies are quasi-public, and many states do not require lottery agencies to abide by the same rules and regulations that govern other state agencies. This even extends to salaries: In Tennessee, the lottery CEO received over $700,000 in salary and bonuses her first year on the job. Lottery supporters in these states argue that a certain amount of autonomy and freedom from government regulation is necessary for the lottery to maximize "profits," but this independence and emphasis on maximizing profits is at odds with responsible government. Even in a state that forces lottery agencies to strictly adhere to government rules and regulations, there will always be tension between the lottery's role as a revenue-raising business and the lottery's role as a government agency. This is unavoidable, even in states that house the agency within another department, such as the department of revenue.

The Vermont lottery website states: "[W]e will design, regulate, promote, distribute, and sell lottery games of chance in Vermont. In doing this we must preserve the integrity of the games, maximize profitability, and make a significant contribution to the Education Fund while maintaining the dignity of the state." The Tax Foundation believes this is impossible.

The main reason states should not be running lotteries is that the lottery is an implicit tax, and a very poorly designed tax. No state government labels lottery profits tax revenue, but they should. The issue is receiving serious consideration for the first time in the North Carolina Court of Appeals, where the court has heard arguments in a case against the state lottery—a case that rests on the question of whether lottery profits are tax revenue. The court's decision could change the way we think of state-run lotteries.

The lottery must be evaluated as a tax, and when we subject it to the tests of sound tax policy, it fails.

In Fiscal Year 2006 lotteries generated over $57 billion in consumer spending, This translated to a profit for state coffers of almost $17 billion. Slightly over half of the money spent on lotteries is returned to players in the form of prizes. After winnings are paid, part of the remainder covers operating costs—including vendor commissions, equipment, administration and advertising—and the rest is transferred to state coffers. The states call their portion "profit" but it is actually implicit tax revenue.

Nationwide, in FY'06, 30% of lottery spending was transferred to state coffers; this portion comprises the implicit tax revenue. Vermont's lottery brought in $104 million in sales, approximately $23 million of which (22%) ended up in state coffers to fund the state departments of education and health.

Lottery proponents argue that a tax is a mandatory payment, and playing the lottery is voluntary, so lottery revenue cannot be tax revenue. But they're confusing the purchase of a product with the payment of the tax on the product. Purchasing a lottery ticket is, of course, voluntary, but the tax portion of the ticket price is not, just as a sales or excise tax is compulsory on a voluntary purchase of alcohol, clothing or books.

We can draw an analogy between the sale of lottery tickets and the sale of alcohol in a state-run liquor store. 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 used for unrelated government programs.

Many lottery supporters reason that voters will be more accepting of a high tax on a recreational activity like gambling, especially one that many people consider immoral or unhealthy. However, the tax code should not be used to impose this type of moral judgment.

What exactly is a good tax? First, a good tax is simple, easy to understand and easy to comply with. However, the administrative burden of operating lotteries makes the tax system more complex and less efficient.

Another test we can use to judge taxes is regressivity. Extensive evidence shows that lotteries are regressive. Some studies, including the National Gambling Impact Study Commission's final report, show that the poor spent more as a dollar amount, while others show that different income groups spend about the same dollar amount, which equals a higher percentage of income for the poor.

Vermont, to its credit, does seem to be more aware of the regressivity problem than some states, and has even run ad campaigns with the message that players shouldn't "bet the farm" because "winning Megabucks is a lot like finding a needle in a [haystack]."

The average Vermont resident spent $168 on the lottery in FY 2006, which is less than both the national average of $191 and the lottery-state average of $203, but still sizable. And the average American spends more on the lottery than on reading materials and attending movies combined. In fact, in Rhode Island, the average adult spends nearly $2,000 per year on the lottery. It seems unlikely that the high-dollar players are all wealthy. Even if they are all upper- or middle-income, the legislature should ask whether it wants to actively encourage people to spend this kind of money on the lottery.

A few years ago, a poll conducted by the Opinion Research Corporation for the Consumer Federation of America and the Financial Planning Association found that Americans are, for the most part, pessimistic about their ability to save for retirement—so pessimistic, in fact, that 21 percent of respondents said playing the lottery is "the most practical strategy for accumulating several hundred thousand dollars" for retirement. Of course, if the lottery were sold and run privately, some people would still spend more than they can afford on the lottery; this happens with many consumer goods and recreational activities and it cannot be prevented by the state—nor should it be. But if Vermont got out of the lottery business, at least it would not be actively promoting and profiting from a product on which the poor spend a disproportionate amount of money, perhaps even to the exclusion of saving for retirement.

Another important principle of sound tax policy is transparency. The tax system should be as clear and simple as possible; taxpayers should understand what is being taxed and what the rates are. Transparency, simply put, is honesty. The lottery tax, however, is hidden. The state creates a monopoly for itself and builds the tax into the price of the tickets, then advertises the lottery as a recreational activity rather than a revenue-raising activity.

A good tax is also economically neutral. The tax system should not favor the consumption of one good over another or distort consumer spending, and since taxes pay for geranial government programs, it is important that they be levied broadly rather than on a subset of the population that happens to enjoy a particular product or service. Other types of gambling are highly taxed but the high government profit rate on lotteries makes the percentage of spending returned to players as prizes lower than in other forms of gambling.

In FY2006, approximately 30 cents of every dollar spent on lotteries was kept by state governments. This translates to an implicit tax rate of 42%—far higher than any state's sales tax and higher than most states' casino taxes. Vermont's rate is 28%, which ranks near the bottom of the list at 40th in the nation. Still, this is 350% higher than the sales tax. Can anyone imagine walking into a Vermont store and being charged a 28% sales tax on a board game, iPod, video game or any other recreational item?

If Vermont wants to make is tax system more principled by quitting the lottery business, it has several options. First, it could continue selling lottery tickets but collect only as much money as is needed to operate the lottery, removing the profit portion. This would constitute a user fee, not an implicit tax. Sales taxes could be levied on tickets, which would bring in some revenue for the general fund. Replacing the state's 28% implicit tax (or "profit") with a much lower, explicit sales tax would not only increase transparency; it would also increase the prize payout rate, which might induce lottery players from neighboring states to cross the border to buy tickets. However, this plan would not remove the state from the lottery business, so it is not ideal.

The second option is the one currently under consideration: leasing the lottery to a private company for a one-time payment plus an annual revenue stream. States that have considered this include: Florida, the District of Columbia, Maryland, New Jersey, Indiana, Illinois, Michigan, New York, and California (some of these states have also considered outright sales).

There are pros and cons to a lease—mostly cons. The only pro is the possibility that state coffers could receive a large, one-time infusion of cash, followed by annual payments from the private vendor. However, there is no guarantee that a private company will bring in more money than the state is currently raising on its own.

The drawback to a lease, from a tax policy standpoint, is that the state would still be involved in the lottery business and would still in effect be imposing a high implicit tax on lottery sales when it collects the annual revenue from the private company. The private company will also set its ticket prices based partly on the amount it must pay the state, not on a market price. In addition, a private company that needs to remit annual payments to the state in addition to worrying about its own bottom line is likely to be more aggressive in marketing and introducing new types of games-something the legislature may not want. A private company that does not have this obligation may not feel as much pressure.

The third option is selling the lottery outright to a private company. This is the best option, and has been considered by Massachusetts, Colorado, Texas, Michigan, Illinois and New Jersey (some of these states have also considered leases).

There are a few potential challenges to consider, however. Lawmakers looking to sell a lottery—or any public asset—for a one-time payment must consider what will happen after the lump-sum payment is used up. Will the money be spent slowly and carefully, and will it last as long as predicted? The executive director of the California Budget Project, commenting on Governor Schwarzenegger's lottery-privatization proposal, said, "The problem is that it's a one-time infusion of cash when we have an ongoing budget shortfall. ... You can only sell an asset once."

However, in FY 2006 Vermont raised only .6% of its own-source revenue from the lottery, less than the average lottery state. If Vermont is going to sell the lottery, now would be the best time, before it becomes more dependent on lottery revenue. Losing the revenue now would likely not be as painful as many people fear given the small fraction of the budget it comprises.

Another drawback to an outright sale is that some jobs would be lost. However, the Vermont Lottery Commission employs only about 20 people, so this is not likely to be a major problem.

Some lawmakers in various states considering lottery sales have expressed concerns that are not as dire as them seem. Some worry that a private company will more aggressively market its products to the poor or offer certain new types of games, such as internet ticket sales, that would induce people to spend beyond their means. However, the legislature, if it wishes to do so, can consider banning certain types of gambling within the state, such as internet lottery ticket sales or video lottery terminals. (However, there is the possibility that such a ban would decrease the amount a private company would be willing to pay for the lottery.)

In addition, it seems likely that a private lottery company would have more sophisticated technology at its disposal and would create more complex games with increased entrainment value. These games could be marketed to upper- and middle-income consumers, just as casinos often cater to an upper-income clientele. Lower-income lottery players tend to prefer numbers games and instant games, which require less effort to produce. It would make sense for a private company to target a customer base with more disposable income rather than attempt to induce lower-income individuals to purchase more lottery tickets. Of course, lower-income lottery players will most likely continue to play the lottery whether it is run by the state or by a private company. Some legislators may worry that a private company would be able to draw in more poor lottery players as well as more upper-income players. However, it is not the job of the state to prevent people from spending beyond their means on private goods and services; it is only the responsibility of the state to refrain from taxing the poor disproportionately.

The advantages of a lottery sale are significant: money from the sale could go a long way if handled wisely; the state would get out of a business that is not appropriate for government; and Vermont's tax system would be more principled. If the legislature removed the monopoly status when it sold the lottery so that multiple companies could operate lotteries in the future, consumers would probably get a better deal as the price of a lottery ticket would be determined by the market—not by the needs of government coffers. In addition, competition in the lottery market would likely lead to greeter accountability and lower prices as companies compete for consumers' business.

No state that has considered lottery privatization has gone through with the plan, and Indiana has even dropped the idea, at least for now. Indiana Governor Mitch Daniels proposed leasing the lottery to a private company and said one company was willing to pay $1 billion plus $200 million in annual payments for the 30-year lease. The money generated would have allegedly funded a life sciences program and a college scholarship program. The proposal passed the senate but stalled in the house, and Daniels finally withdrew it. He said he would not put forth the plan again in the legislative session because lawmakers would be too busy considering property tax reforms.

We can only speculate about the stalling in these states that seemed so enthusiastic about privatization at first. Most likely, policymakers and education groups fear that private companies would not bring in as much revenue for state coffers as the state lottery agency has been generating. There is a fear of losing an asset that has been producing a steady stream of implicit tax revenue.

There are some other reasonable theories as to why these plans have not been implemented, and these theories shed some light on the advantage a lottery sale would have over a lease in Vermont (or any state). Many states want to retain a certain degree of control over any private company that would lease or buy the lottery. Indiana, for example, wanted to ban keno and video poker. The more controls and limitations the state puts into the contract with a potential investor, the less the investor will be willing to pay. This tension between the state's desire to raise significant revenue from the sale or lease and the state's desire to maintain control over the lottery's operations may be a major stumbling block.

In addition, states considering a lease agreement must be aware that, in order to make annual payments to the state and still make a profit, a private operator would need to significantly increase revenue, which would require, at least initially, reduced prize payouts, increased ticket prices, or more aggressive marketing. Therefore, a private company may prefer an outright sale rather than a lease; it would be financially free after the initial lump-sum payment and it would have more autonomy in terms of games offered and marketing strategies used. Of course, in the ideal lottery sale, the state would still receive some revenue after the initial payment because it would impose sales taxes on lottery tickets just as on other recreational goods and services. A state that wished to continue extracting the same percentage of revenue from the lottery might consider imposing a very high excise tax rate on the lottery industry, which would bring problems of its own, (such as regressivity), but at least this would be more transparent than the current system.

For these reasons, the Tax Foundation believes Vermont should sell its lottery to a private company for a one-time payment and apply the sales tax to lottery tickets. While many policymakers would no doubt bemoan the decrease in revenue, the amount lost would be smaller than many would anticipate, and the small financial loss would be well worth the improvements to the state's tax system.

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