January 21, 2010

Hon. Edmund G. Brown Jr.
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Krystal Paris
Initiative Coordinator

Dear Attorney General Brown:

Pursuant to Elections Code Section 9005, we have reviewed the proposed statutory initiative relating to the California Lottery (A.G. File No. 09-0099).

BACKGROUND

Existing Lottery Laws

Lottery Created by a Voter-Approved Measure. California voters approved Proposition 37 in 1984. Proposition 37 authorized creation of the California Lottery and dedicated lottery profits to education. It created the California State Lottery Commission, which consists of five persons appointed by the Governor and confirmed by the State Senate. The commission oversees the 640-person state department that administers the lottery.

Laws Governing Lottery Funds. Proposition 37 directs how lottery funds are used. It requires that 50 percent of these funds be returned to lottery players as prizes. (This means that, on average, a lottery player in California claims about 50 cents in prizes for every dollar spent on tickets.) Currently, the lottery may spend no more than 16 percent of its ticket sales on lottery operating expenses. The law dedicates lottery profits—the funds remaining after payment of prizes and lottery operating expenses—to public educational institutions, including school districts, community colleges, the University of California system, and the California State University system. These payments to educational institutions must equal at least 34 percent of the funds generated from lottery ticket sales each year.

Current Lottery Funding for Education

Lottery Payments Are a Small Part of Education Funding. In the 2008-09 fiscal year, the lottery sold about $3 billion of tickets, paid out $1.6 billion in prizes, and spent

$396 million on operating expenses, most of which consist of sales commissions, bonuses, and other payments to the retailers that sell lottery tickets. This left just over $1 billion in lottery profits, which were distributed to public educational entities based on their number of students. This amount represents only a small part of the overall budget of California's public education institutions. For kindergarten through twelfth-grade schools, for example, lottery funds made up just over 1 percent of all revenues in 2008-09.

PROPOSAL

Changes to Lottery Operations

More Flexibility for Lottery in Its Prize Payouts. This measure gives the lottery the flexibility to increase the percentage of lottery funds returned to players as prizes. Higher prize payouts can attract more spending for lottery tickets and increase lottery profits. Under this measure, the lottery commission could set prize payouts above 50 percent of lottery sales—at the level it determines will produce the maximum amount of lottery profits to be provided to educational entities each year.

Changes to Laws on Lottery Operating Expenses. This measure reduces the maximum amount of lottery operating expenses from 16 percent of lottery funds each year to 13 percent of these funds. (Since the lottery currently spends only about 13 percent of lottery funds—less than the maximum now allowed—on operating expenses, this change probably would have little or no immediate effect on lottery operations.)

Lottery Operating Changes Could Be Repealed in Certain Instances. This measure requires the State Controller and the state's Director of Finance to review the total amount of funds provided by the lottery to educational entities in each of the first five fiscal years after its effective date. If in any of those fiscal years the amount of funds provided to educational entities is less than the amount provided to educational entities in the last full fiscal year prior to this measure taking effect, then all of the proposed lottery operating changes described above would be repealed. If this occurred, the lottery would resume operating under the laws that were in effect prior to approval of this measure.

Lottery-Related Reporting Requirements

This measure requires various lottery-related reports to be posted to the Web site of the California Lottery. These requirements would be permanent, regardless of whether or not the proposed operating changes described above are repealed in the first five fiscal years after this measure takes effect.

FISCAL EFFECTS

Increased Prize Payouts Are Likely to Increase Lottery Sales and Profits. Each Californian spends an average of $83 each year on lottery tickets—considerably less than the average resident of other states with a lottery. There are probably many reasons this is so, including the other entertainment and gambling options available for residents here. California's relatively low lottery prize payouts (about 50 cents in prizes for every dollar spent on lottery tickets) likely also contributes to the lottery's relatively weak sales. Higher prize payouts appear to attract more players and greater spending for lottery tickets. For example, the Massachusetts State Lottery—one of the leading lotteries in sales per resident—returns over 70 percent of its funds to players as prizes. In 2002, the Florida Legislature authorized that state's lottery to grow its prize payouts. Within five years, Florida Lottery sales grew substantially. Based on the evidence from other states, we conclude that if voters approve this measure, sales and profits of the California Lottery could grow significantly compared to how much they would grow under current law. This growth could result in future lottery sales being substantially higher. Because a greater share of lottery profits would be given back to players as prizes, lottery *profits* would grow by a smaller percentage than lottery sales. We estimate that lottery profits would increase by hundreds of millions of dollars per year compared to what they would be under current law.

Choices by Consumers and Lottery Officials Would Affect Growth. While lottery sales and profits could grow substantially if this proposal is approved, the precise effects of this measure cannot be predicted. The amount of sales and profit growth would depend on how California consumers react to the products offered by the lottery in the future, as well as trends in the state's economy. In addition, the lottery's financial performance would depend on many decisions made by the commission and lottery staff. They would decide, among other things, the level of lottery prize payouts, how lottery games will be marketed to the public, and how lottery retailers throughout California will be encouraged to sell lottery tickets. If any of these factors or similar factors contribute to a decline in lottery sales or profits during the first five full fiscal years after this measure is approved, the lottery would resume operating under existing laws governing the use of its funds. In this scenario, this measure would have no significant long-term effect.

Summary

The measure would have the following major fiscal effect on state and local governments:

- Estimated increase of several hundred million dollars per year in lottery profits paid to public educational entities. Exact amount of lottery sales and profit growth, if any, would depend on choices by consumers and lottery officials.

Sincerely,

Mac Taylor
Legislative Analyst

Ana J. Matosantos
Director of Finance