PROPOSITION 37
THE CALIFORNIA STATE LOTTERY INITIATIVE

AUGUST 22, 1984

LEGISLATIVE ANALYST

STATE OF CALIFORNIA

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PROPOSITION 37--THE CALIFORNIA STATE LOTTERY INITIATIVE

STATEMENT TO THE ASSEMBLY COMMITTEE ON GOVERNMENTAL ORGANIZATION SACRAMENTO, AUGUST 22, 1984

MR. CHAIRMAN AND MEMBERS:

YOU HAVE ASKED THAT WE PROVIDE TESTIMONY REGARDING THE FISCAL EFFECTS OF THE CALIFORNIA STATE LOTTERY INITIATIVE, WHICH WILL APPEAR AS PROPOSITION 37 ON THE STATEWIDE BALLOT ON NOVEMBER 6, 1984. IN PARTICULAR, YOU HAVE ASKED THAT WE PROVIDE AN OVERVIEW OF THE INITIATIVE'S PROVISIONS AND THEN DISCUSS EIGHT SPECIFIC QUESTIONS REGARDING THE FISCAL IMPLICATIONS WHICH THIS MEASURE, IF APPROVED, WOULD HAVE.

A. MAJOR PROVISIONS OF THE INITIATIVE

PROPOSITION 37 WOULD MAKE BOTH CONSTITUTIONAL AND STATUTORY LAW CHANGES REGARDING GAMBLING ACTIVITY IN CALIFORNIA.

1. CONSTITUTIONAL PROVISIONS OF THE INITIATIVE

PROPOSITION 37 WOULD AMEND THE CALIFORNIA CONSTITUTION IN TWO WAYS:

- IT WOULD AUTHORIZE ESTABLISHMENT OF A STATEWIDE LOTTERY IN CALIFORNIA. (THE CONSTITUTION PRESENTLY PROHIBITS LOTTERIES).
- IT WOULD PROHIBIT GAMBLING CASINOS IN CALIFORNIA OF THE TYPE THAT EXIST IN NEVADA AND NEW JERSEY. (CASINO GAMBLING CURRENTLY IS PROHIBITED WITHIN CALIFORNIA BY A STATUTE, BUT NOT BY THE CONSTITUTION.)

2. STATUTORY PROVISIONS OF THE INITIATIVE

PROPOSITION 37 WOULD ALSO ENACT AN INITIATIVE STATUTE, CALLED THE CALIFORNIA STATE LOTTERY ACT OF 1984, WHICH PROVIDES FOR THE ACTUAL ESTABLISHMENT OF A STATE-OPERATED LOTTERY. THE ACT'S MAIN PROVISIONS ARE AS FOLLOWS:

A. LOTTERY ADMINISTRATION

THE ACT WOULD ESTABLISH A CALIFORNIA STATE LOTTERY COMMISSION AND GIVE IT BROAD POWERS TO OVERSEE THE OPERATIONS OF THE STATEWIDE LOTTERY, WITH THE STATED OBJECTIVE BEING TO MAXIMIZE NET REVENUES FROM THE LOTTERY. THE COMMISSION WOULD BE RESPONSIBLE FOR DETERMINING THE TYPES OF LOTTERIES TO BE HELD, THE FREQUENCY OF LOTTERY DRAWINGS, THE PRICE OF LOTTERY TICKETS, THE NUMBER AND AMOUNT OF LOTTERY PRIZES, AND THE LOCATIONS WHERE LOTTERY TICKETS MAY BE SOLD.

THE COMMISSION WOULD HAVE FIVE MEMBERS WHO, ALONG WITH A LOTTERY DIRECTOR, WOULD BE APPOINTED BY THE GOVERNOR AND CONFIRMED BY THE CALIFORNIA SENATE. THE MEASURE WOULD REQUIRE THAT AT LEAST ONE OF THE FIVE COMMISSIONERS HAVE A BACKGROUND IN LAW ENFORCEMENT, AND THAT AT LEAST ONE BE A CERTIFIED PUBLIC ACCOUNTANT. NO MORE THAN THREE OF THE FIVE COMMISSIONERS COULD BE MEMBERS OF THE SAME POLITICAL PARTY.

THE COMMISSION WOULD BE REQUIRED TO MAKE QUARTERLY REPORTS ON THE PERFORMANCE OF THE LOTTERY. THE DIRECTOR WOULD BE REQUIRED TO ARRANGE FOR STUDIES OF HOW THE LOTTERY COULD BE OPERATED MOST EFFECTIVELY, WHO PARTICIPATES IN THE LOTTERY, AND THE BEST MEANS OF PROMOTING THE LOTTERY SO AS TO MAXIMIZE LOTTERY REVENUES.

B. LOTTERY IMPLEMENTATION

THE COMMISSION WOULD BE REQUIRED TO BEGIN PUBLIC SALE OF LOTTERY TICKETS NO LATER THAN 135 DAYS AFTER THE EFFECTIVE DATE OF THIS MEASURE (THAT IS, BY APRIL 1985). LOTTERY TICKETS COULD BE PURCHASED ONLY BY INDIVIDUALS AGED 18 YEARS OR OLDER. THE MEASURE WOULD PROVIDE THE COMMISSION WITH A $16.5 MILLION TEMPORARY LINE OF CREDIT FROM THE GENERAL

FUND TO COVER THE START-UP COSTS ASSOCIATED WITH A STATE LOTTERY. THE COMMISSION COULD DRAW ON THIS LINE OF CREDIT DURING THE 12 MONTHS FOLLOWING THE EFFECTIVE DATE OF THE MEASURE. THE COMMISSION WOULD HAVE TO REPAY ANY BORROWED FUNDS, WITH INTEREST AT AN ANNUAL RATE OF 10 PERCENT, WITHIN 12 MONTHS OF RECEIVING THE FUNDS.

c. ALLOCATIONS OF THE PROCEEDS FROM LOTTERY SALES

THE MEASURE WOULD REQUIRE ALL REVENUES FROM LOTTERY SALES TO BE DEPOSITED INTO A NEW SPECIAL FUND CALLED THE STATE LOTTERY FUND. FIFTY PERCENT OF THESE PROCEEDS FROM LOTTERY TICKET SALES WOULD BE PAID OUT AS LOTTERY PRIZES, AND A MAXIMUM OF 16 PERCENT COULD BE USED FOR ADMINISTRATIVE COSTS (INCLUDING COMMISSIONS TO SELLERS OF LOTTERY TICKETS). THE LOTTERY PRIZES WOULD BE EXEMPT FROM STATE (BUT NOT FEDERAL) INCOME TAXES. THE REMAINDER OF THE PROCEEDS FROM TICKET SALES--AT LEAST 34 PERCENT OF THE TOTAL--WOULD BE TRANSFERRED INTO A NEW SPECIAL FUND (THE STATE LOTTERY EDUCATION FUND) FROM WHICH MONIES WOULD BE CONTINUOUSLY APPROPRIATED FOR THE BENEFIT OF PUBLIC EDUCATION. ANY UNCLAIMED LOTTERY PRIZES AND UNUSED FUNDS AVAILABLE FOR ADMINISTRATIVE COSTS WOULD ALSO BE PLACED INTO THIS FUND.

THE MEASURE REQUIRES THAT THE FUNDS MADE AVAILABLE FOR PUBLIC EDUCATION BE DIVIDED AMONG THE FOLLOWING FOUR CATEGORIES OF PUBLIC EDUCATION: KINDERGARTEN-THROUGH-TWELFTH GRADE (K-12), COMMUNITY COLLEGES, THE CALIFORNIA STATE UNIVERSITY (CSU), AND THE UNIVERSITY OF CALIFORNIA (UC). THE FUNDS WOULD BE DISTRIBUTED PERIODICALLY BY THE STATE CONTROLLER ON A "PER CAPITA" BASIS. THIS PROBABLY WOULD BE INTERPRETED IN TERMS OF AVERAGE DAILY ATTENDANCE OR FULL-TIME EQUIVALENT ENROLLMENT. THE MEASURE

STATES THE INTENT THAT THE FUNDS MADE AVAILABLE FOR PUBLIC EDUCATION ARE TO BE USED TO AUGMENT (RATHER THAN SUBSTITUTE FOR) FUNDS ALREADY ALLOCATED FOR PUBLIC EDUCATION IN CALIFORNIA, AND THAT THE FUNDS ARE TO BE SPENT EXCLUSIVELY FOR INSTRUCTIONAL PURPOSES.

B. FISCAL EFFECTS OF THE INITIATIVE

YOU HAVE ASKED THAT WE DISCUSS THE FOLLOWING EIGHT SPECIFIC QUESTIONS REGARDING THE FISCAL EFFECTS OF PROPOSITION 37. EACH OF THESE QUESTIONS IS SEPARATELY ADDRESSED BELOW.

1. THE AMOUNT OF NET REVENUES WHICH THE LOTTERY WOULD PRODUCE

YOU HAVE ASKED WHAT OUR ESTIMATE IS OF HOW MUCH IN NET REVENUES WOULD BE MADE AVAILABLE FOR PUBLIC EDUCATION IF THE LOTTERY INITIATIVE SHOULD PASS, AND WHEN THESE REVENUES WOULD BECOME AVAILABLE.

RESPONSE

ESTIMATING THE AMOUNT OF LOTTERY PROCEEDS AVAILABLE TO PUBLIC EDUCATION INVOLVES TWO STEPS:

- ESTIMATING THE TOTAL DOLLAR VOLUME OF LOTTERY TICKET SALES WHICH WILL OCCUR, AND
- MULTIPLYING THIS SALES VOLUME BY THE SHARE OF LOTTERY RECEIPTS WHICH IS TO BE ALLOCATED TO PUBLIC EDUCATION.

SHARE OF LOTTERY RECEIPTS GOING TO EDUCATION. AS NOTED EARLIER, PROPOSITION 37 REQUIRES THAT PUBLIC EDUCATION RECEIVE A MINIMUM OF 34 PERCENT OF MONIES RAISED FROM THE SALE OF LOTTERY TICKETS. IN ADDITION, PUBLIC EDUCATION IS TO RECEIVE ALL UNCLAIMED PRIZE MONIES, PLUS THE AMOUNT BY WHICH THE EXPENSES INCURRED IN OPERATING THE LOTTERY ARE LESS THAN 16 PERCENT OF TICKET SALES. WE HAVE NO WAY OF KNOWING FOR SURE EXACTLY WHAT

THE VOLUME OF UNCLAIMED PRIZE MONIES OR THE EXPENSES OF LOTTERY OPERATIONS WILL BE IN CALIFORNIA AS A PERCENT OF SALES. HOWEVER, BASED ON THE EXPERIENCE OF OTHER STATES, WE BELIEVE THAT THESE TWO FACTORS COULD, ONCE THE LOTTERY IS FULLY OPERATIONAL SO THAT START-UP COSTS ARE NO LONGER A FACTOR AND ON-GOING EXPENSES ARE SPREAD OVER A LARGE SALES BASE, ADD AN ADDITIONAL 6 PERCENT TO THE SHARE OF TICKET SALES ALLOCATED TO EDUCATION. GIVEN THIS, WE BELIEVE THAT PUBLIC EDUCATION COULD RECEIVE 40 PERCENT OF LOTTERY SALES RECEIPTS, ASSUMING A FULLY-OPERATIONAL LOTTERY.

VOLUME OF LOTTERY TICKET SALES. IT IS DIFFICULT TO ACCURATELY PREDICT AT THIS TIME THE AMOUNT OF LOTTERY TICKET SALES WHICH WOULD OCCUR IN CALIFORNIA UNDER PROPOSITION 37. THERE ARE SEVERAL REASONS FOR THIS. FOR EXAMPLE:

- THE INITIATIVE DOES NOT SPECIFY WHAT TYPES OF LOTTERY GAMES WILL BE MADE AVAILABLE IN CALIFORNIA, HOW FREQUENTLY THE GAMES WILL BE PLAYED, OR WHAT THE NUMBER AND LOCATIONS OF LOTTERY TICKET SALES OUTLETS WILL BE.
- BECAUSE CALIFORNIA HAS NEVER HAD A LOTTERY BEFORE, THERE IS NO WAY OF KNOWING IN ADVANCE EXACTLY HOW CALIFORNIANS WILL RESPOND TO DIFFERENT LOTTERY GAMES.
- DATA ON LOTTERY TICKET SALES ARE AVAILABLE FOR LOTTERIES IN 17 OTHER STATES AND THE DISTRICT OF COLUMBIA, AND ONE CERTAINLY CAN ATTEMPT TO USE THESE DATA TO MAKE INFERENCES ABOUT THE POTENTIAL VOLUME OF CALIFORNIA LOTTERY TICKET SALES. HOWEVER, IN ORDER TO DO THIS IN A STATISTICALLY-VALID MANNER, IT IS FIRST NECESSARY TO SEPARATE OUT THE INDEPENDENT INFLUENCES OF THE MANY FACTORS THAT

DETERMINE LOTTERY SALES IN OTHER STATES, SO THAT CALIFORNIA'S OWN UNIQUE CHARACTERISTICS CAN BE TAKEN INTO ACCOUNT WHEN PROJECTING LOTTERY SALES. UNFORTUNATELY, HOWEVER, ACCURATELY IDENTIFYING THE SEPARATE EFFECTS OF ALL OF THESE FACTORS IS AN EXTREMELY COMPLEX TASK, AND WE ARE NOT AWARE OF ANYONE WHO HAS BEEN ABLE TO ACCOMPLISH THIS IN A TOTALLY SATISFACTORY WAY.

- MOST STATES HAVE EITHER RECENTLY EXPANDED THEIR LOTTERY OPERATIONS TO INCLUDE "LOTTO" GAMES, OR PLAN TO DO SO IN THE NEAR FUTURE. LOTTO GAMES REPRESENT THE FASTEST-GROWING FORM OF LOTTERY BETTING RIGHT NOW, AND THE EVIDENCE SO FAR IS THAT THEY COULD BECOME TREMENDOUSLY POPULAR. HOWEVER, BECAUSE THEY ARE RELATIVELY NEW, NO ONE CAN BE SURE FROM THE EXPERIENCES-TO-DATE OF OTHER STATES WHAT TYPES OF SALES LEVELS LOTTO GAMES COULD PRODUCE IN CALIFORNIA, ONCE THEY ARE FULLY PHASED-IN.

GIVEN THESE PROBLEMS, WE HAVE CONCLUDED THAT THE BEST APPROACH TO PROJECTING CALIFORNIA LOTTERY SALES AT THIS TIME IS TO REVIEW THE TOTAL AND PER CAPITA LOTTERY SALES LEVELS IN OTHER STATES (TABLE 1), AND THEN TO (A) FOCUS ON STATES WHICH ARE EITHER LARGE INDUSTRIAL STATES LIKE CALIFORNIA OR GEOGRAPHICALLY PROXIMATE TO CALIFORNIA AND (B) ADJUST FOR THE FACT THAT LOTTERY "NUMBERS GAMES" MIGHT NEVER BECOME AS IMPORTANT A SOURCE OF LOTTERY SALES IN CALIFORNIA AS IN THE EAST AND MIDWEST WHERE, UNLIKE IN CALIFORNIA, NUMBER GAMES HAVE BEEN POPULAR FOR DECADES.

USING THIS APPROACH, WE ESTIMATE THAT LOTTERY SALES IN CALIFORNIA WOULD BE ABOUT $50 PER CAPITA, OR ABOUT $1.25 BILLION FOR THE STATE AS A WHOLE ONCE A LOTTERY IS FULLY OPERATIONAL. THIS VOLUME OF SALES WOULD

TABLE 1

TOTAL AND PER CAPITA LOTTERY SALES IN 1982-83 AND 1983-84

STATE	TOTAL LOTTERY SALES (MILLIONS OF DOLLARS)[A] 1982-83	1983-84	PER CAPITAL LOTTERY SALES 1982-83	1983-84
ARIZONA	$75	$60	$26	$20
COLORADO	137[B]	118	45[B]	38
CONNECTICUT	188	250	60	80
DELAWARE	30	33	50	55
DISTRICT OF COLUMBIA	54[C]	98	86[C]	157
ILLINOIS	516	914	45	80
MAINE	13	16	12	14
MARYLAND	463	537	108	125
MASSACHUSSETTS	316	450[D]	55	78[D]
MICHIGAN	553	621	61	68
NEW HAMPSHIRE	14	18	15	19
NEW JERSEY	693	800	93	107
NEW YORK	645	889	37	50
OHIO	397	600	37	56
PENNSYLVANIA	885	1,236	75	104
RHODE ISLAND	44	53	46	55
VERMONT	5	5	9	10
WASHINGTON	200[E]	165	47[E]	38
ALL LOTTERY STATES	$5,228	$6,863	$50[F]	$64[F]

A. DATA FROM STATE LOTTERY COMMISSIONS AND PUBLIC GAMING RESEARCH INSTITUTE. DATA FOR 1983-84 ARE PRELIMINARY ESTIMATES FOR CERTAIN STATES, INCLUDING NEW JERSEY AND OHIO.
B. LOTTERY SALES BEGAN JANUARY 24, 1983.
C. LOTTERY SALES BEGAN AUGUST 25, 1982.
D. REFLECTS LOTTERY SALES FOR THE FIRST 11 MONTHS OF THE FISCAL YEAR.
E. LOTTERY SALES BEGAN NOVEMBER 15, 1982.
F. UNWEIGHTED AVERAGE OF ALL LOTTERY STATES.

YIELD $500 MILLION IN ANNUAL REVENUES FOR CALIFORNIA PUBLIC EDUCATION, BASED ON THE ASSUMPTION ABOVE THAT EDUCATION RECEIVES A 40 PERCENT SHARE.

OUR ESTIMATE OF $500 MILLION IN NET REVENUES IS LESS THAN THE $700 MILLION ESTIMATE ASCRIBED TO THE INITIATIVE'S PROPONENTS. THIS IS BECAUSE THE $700 MILLION ESTIMATE IS BASED ON PARTIAL YEAR SALES DATA FOR TWO STATES (WASHINGTON AND COLORADO) DURING THE EARLY MONTHS OF THEIR FIRST YEAR OF OPERATION (1982-83). THESE SALES VOLUMES ARE NOT REPRESENTATIVE OF THE ONGOING EFFECTS OF THE LOTTERIES. IN CONTRAST, OUR FIGURE IS BASED ON LOTTERY PERFORMANCE IN THESE TWO STATES PLUS IN TEN OTHER STATES AS WELL, IN THE MOST RECENT FISCAL YEAR (1983-84).

THUS, OUR ESTIMATE REFLECTS A BROADER SPECTRUM AND MORE RECENT EXPERIENCE OF LOTTERY ACTIVITY THAN DOES THE $700 MILLION ESTIMATE.

WHEN LOTTERY REVENUES WOULD BECOME AVAILABLE. BECAUSE PROPOSITION 37 REQUIRES THE PUBLIC SALE OF LOTTERY TICKETS BY APRIL 1985, REVENUES WOULD FIRST BECOME AVAILABLE IN 1984-85. HOWEVER, THESE REVENUES WOULD BE FAR LESS THAN $500 MILLION, BECAUSE THERE WOULD ONLY BE A PARTIAL YEAR EFFECT IN 1984-85. IN 1985-86, REVENUES WOULD ALSO BE LESS THAN $500 MILLION, BECAUSE IT TAKES TIME TO FULLY IMPLEMENT AN ARRAY OF LOTTERY GAMES AND REALIZE THEIR FULL REVENUE POTENTIAL. FOR EXAMPLE, LOTTERY OFFICIALS IN OTHER STATES INDICATED TO US THAT IT CAN TAKE A YEAR OR MORE TO BEGIN LOTTO GAMES, DUE TO THE TIME REQUIRED TO IMPLEMENT THE NECESSARY "ON-LINE" COMPUTER EQUIPMENT AND TO ESTABLISH SATISFACTORY SECURITY SYSTEMS. CONSEQUENTLY, THE FULL ONGOING REVENUE IMPACT OF THE MEASURE PROBABLY WOULD NOT BE FELT UNTIL 1986-87.

2. THE DISTRIBUTION OF LOTTERY REVENUES AMONGST EDUCATION CATEGORIES

YOU HAVE ASKED HOW LOTTERY REVENUES WOULD BE ALLOCATED AMONGST THE STATE'S FOUR MAJOR EDUCATIONAL SYSTEMS--K-12, COMMUNITY COLLEGES, CALIFORNIA STATE UNIVERSITY (CSU), AND THE UNIVERSITY OF CALIFORNIA (UC).

RESPONSE

PROPOSITION 37 REQUIRES THAT THE LOTTERY REVENUES ALLOCATED FOR EDUCATIONAL PURPOSES SHALL BE DISTRIBUTED AMONGST THESE FOUR EDUCATIONAL CATEGORIES ON A "PER CAPITA" BASIS. WE BELIEVE THAT THIS PROVISION WOULD BE INTERPRETED AS REQUIRING THE FUNDS TO BE DISTRIBUTED IN EQUAL AMOUNTS PER AVERAGE DAILY ATTENDANCE (THE MEASUREMENT THE INITIATIVE REFERS TO FOR K-12 AND COMMUNITY COLLEGES) OR FULL-TIME EQUIVALENT ENROLLMENT (THE MEASUREMENT THE INITIATIVE REFERS TO FOR CSU AND UC). BASED UPON CURRENT 1984-85 ADA PROJECTIONS FOR K-12 AND COMMUNITY COLLEGES AND FTE PROJECTIONS FOR CSU AND UC, THE DISTRIBUTION OF LOTTERY REVENUES AMONGST EDUCATIONAL CATEGORIES WOULD BE ABOUT 80.1 PERCENT FOR K-12, 13.0 PERCENT FOR COMMUNITY COLLEGES, 4.5 PERCENT FOR CSU, AND 2.4 PERCENT FOR UC.

3. COMPARISON OF LOTTERY REVENUES ALLOCATED TO EDUCATION WITH CURRENT EDUCATIONAL FUNDING

YOU HAVE ASKED HOW THE LOTTERY REVENUES TO BE RECEIVED BY PUBLIC EDUCATIONAL INSTITUTIONS COMPARES WITH THE FUNDING CURRENTLY PROVIDED BY THE STATE TO THESE INSTITUTIONS FOR INSTRUCTIONAL PURPOSES.

RESPONSE

TABLE 2 SUMMARIES THE FUNDING LEVELS IN 1983-84 AND 1984-85 PROVIDED BY THE STATE FOR K-12, COMMUNITY COLLEGES, CSU AND UC. THESE FIGURES

TABLE 2

CURRENT STATE FUNDING AND ESTIMATED
STATE LOTTERY REVENUES FOR EDUCATIONAL
CATEGORIES IN CALIFORNIA
(IN MILLIONS)

EDUCATIONAL CATEGORY	CURRENT EDUCATIONAL FUNDING[A] 1983-84	CURRENT EDUCATIONAL FUNDING[A] 1984-85	PROJECTED EDUCATIONAL REVENUES FROM A FULLY-OPERATIONAL LOTTERY AMOUNT	PROJECTED EDUCATIONAL REVENUES FROM A FULLY-OPERATIONAL LOTTERY PERCENT OF 1984-85 FUNDING
1. K-12 EDUCATION	$8,429	$9,636	$400	4.2%
2. POSTSECONDARY EDUCATION				
A. COMMUNITY COLLEGES	1,073	1,101	65	5.9
B. CSU	955	1,152	23	1.9
C. UC	1,125	1,375	12	0.9
SUBTOTAL	$3,152	$3,628	$100	2.8%
TOTAL, K-12 AND POST-SECONDARY EDUCATION	$11,581	$13,264	$500	3.8%

A. DETAIL MAY NOT ADD TO TOTALS DUE TO ROUNDING. FIGURES INCLUDE STATE SUPPORT FROM THE GENERAL FUND AND OTHER STATE FUNDS, BUT EXCLUDE FEDERAL FUNDING AND MAJOR CAPITAL OUTLAY EXPENDITURES. FIGURES FOR CSU AND UC CONTAIN CERTAIN FUNDING USED FOR RESEARCH ACTIVITIES WHICH CANNOT BE SEPARATELY IDENTIFIED USING CURRENTLY AVAILABLE DATA.

INCLUDE SUPPORT FROM BOTH THE GENERAL FUND AND OTHER STATE FUNDS, AND EXCLUDE FEDERAL FUNDS AND MAJOR CAPITAL OUTLAY FUNDING.

THE TABLE INDICATES THAT THE REVENUES AVAILABLE TO EDUCATION FROM A FULLY OPERATIONAL LOTTERY WOULD AMOUNT TO, AS A PERCENT OF 1984-85 STATE EDUCATIONAL FUNDING, ABOUT 4.2 PERCENT FOR K-12, 5.9 PERCENT FOR COMMUNITY COLLEGES, 1.9 PERCENT FOR CSU, 0.9 PERCENT FOR UC, AND 3.8 PERCENT FOR ALL OF THESE EDUCATIONAL CATEGORIES COMBINED.

4. THE STABILITY OF LOTTERY REVENUES OVER TIME

YOU HAVE ASKED WHAT OUR OPINION IS REGARDING THE STABILITY OF LOTTERY REVENUES OVER TIME AND, IN PARTICULAR, WHETHER LOTTERY REVENUES CAN BE RELIED UPON AS A STABLE FUNDING SOURCE FOR PUBLIC EDUCATION.

RESPONSE

THERE ARE TWO SEPARATE ASPECTS OF YOUR QUESTION. ONE ASPECT INVOLVES WHETHER, ON A LONG-TERM BASIS, LOTTERY REVENUES CAN BE EXPECTED TO "HOLD THEIR OWN" AND GROW IN STEP WITH THE GENERAL ECONOMY, AS OPPOSED TO "FALLING OFF" OVER TIME. THE SECOND ASPECT INVOLVES THE EXTENT TO WHICH, OVER THE NORMAL COURSE OF THE BUSINESS CYCLE, LOTTERY REVENUES WILL EXPERIENCE SHORT-TERM VARIABILITY.

REGARDING THE FIRST FACTOR--LONG-TERM STABILITY--THERE SEEMS TO SOME EVIDENCE FROM THE EXPERIENCES OF LOTTERIES IN OTHER STATES THAT LOTTERY GAMES FREQUENTLY GENERATE A RUSH OF ENTHUSIASM WHEN THEY ARE FIRST INTRODUCED, WITH REVENUES TO MATCH; HOWEVER, SALES LATER SAG AS THE NOVELTY OF THE GAMES WEARS OFF, UNLESS NEW VERSIONS ARE INTRODUCED. FOR EXAMPLE, THIS SEEMS TO HAVE OCCURRED IN BOTH ARIZONA (WHERE SALES DECLINED FROM $114 MILLION IN 1981-82 TO $75 MILLION IN 1982-83 AND $60 MILLION IN 1983-84),

COLORADO (WHERE SALES DECLINED FROM $137 MILLION IN THE LAST FIVE MONTHS OF 1982-83 TO $118 MILLION FOR ALL OF 1983-84) AND WASHINGTON (WHERE SALES DECLINED FROM $200 MILLION IN THE LAST 7½ MONTHS OF 1982-83 TO $165 MILLION FOR ALL OF 1983-84). OUR OWN EXAMINATION OF INTERSTATE DIFFERENCES IN PER CAPITA LEVELS OF LOTTERY SALES INDICATES THAT, WHEN OTHER FACTORS SUCH AS HOUSEHOLD INCOME, UNEMPLOYMENT RATES AND THE PREVALENCE OF ALTERNATIVE TYPES OF LEGAL GAMBLING ARE ADJUSTED FOR, LOTTERY WAGERING TENDS TO FALL-OFF AS THE NUMBER OF YEARS A LOTTERY HAS BEEN IN EXISTENCE INCREASES. GIVEN THIS, WE BELIEVE THAT THERE WOULD BE SOME TENDENCY, AT LEAST FOR A PERIOD FOLLOWING THE ESTABLISHMENT OF A FULLY-OPERATIONAL LOTTERY, FOR THERE TO BE SOME FALL-OFF IN LOTTERY REVENUES UNLESS SUFFICIENTLY INNOVATIVE CHANGES IN LOTTERY GAMES THAT FUELED THE ENTHUSIASM OF BETTORS WERE CONTINUOUSLY MADE.

REGARDING THE SECOND FACTOR--<u>SHORT-RUN VARIABILITY</u> IN LOTTERY REVENUES IN RESPONSE TO FLUCTUATIONS IN ECONOMIC CONDITIONS--SEVERAL OPPOSING FORCES APPEAR TO BE AT WORK. ON THE ONE HAND, OUR INTERSTATE EXAMINATION OF LOTTERY ACTIVITY SUGGESTS THAT LOTTERY WAGERING APPEARS TO RISE AND FALL WITH INCOME. ON THE OTHER HAND, LOTTERY WAGERING ALSO SEEMS TO RISE AND FALL WITH THE UNEMPLOYMENT RATE. OF THESE TWO EFFECTS, THE CORRELATION BETWEEN LOTTERY WAGERING AND INCOME IS SOMEWHAT STRONGER THAN THAT BETWEEN WAGERING AND UNEMPLOYMENT. AS A RESULT, IT APPEARS THAT LOTTERY REVENUES CAN BE EXPECTED, ON BALANCE, TO RISE AND FALL <u>WITH</u> ECONOMIC ACTIVITY GENERALLY. IN THIS SENSE, SOME MIGHT CATEGORIZE LOTTERIES AS AN UNSTABLE SOURCE OF REVENUES IN THE SHORT-RUN SENSE. HOWEVER, IT SHOULD BE REMEMBERED THAT ALL OF THE STATE'S THREE MAJOR

GENERAL FUND INCOME SOURCES--THE PERSONAL INCOME TAX, THE SALES AND USE TAX, AND THE BANK AND CORPORATION TAX--ALSO SHARE THIS SAME GENERAL CHARACTERISTIC OF RISING AND FALLING ALONG WITH THE LEVEL OF ECONOMIC ACTIVITY GENERALLY.

5. THE ALLOCATION OF LOTTERY PROCEEDS IN OTHER STATES

YOU HAVE ASKED HOW THE ALLOCATION OF GROSS LOTTERY SALES RECEIPTS UNDER PROPOSITION 37 BETWEEN PRIZES, ADMINISTRATIVE EXPENSES AND PUBLIC PURPOSES COMPARES WITH THE ALLOCATION IN OTHER STATE LOTTERIES.

RESPONSE

TABLE 3 SUMMARIZES HOW EACH LOTTERY STATE SPLIT ITS GROSS LOTTERY TICKET SALES RECEIPTS AMONGST PRIZES, EXPENSES AND PUBLIC PURPOSES IN 1983-84. WHEN COMPARING THESE ALLOCATIONS TO THE ALLOCATION PROPOSED IN PROPOSITION 37 FOR CALIFORNIA, IT IS IMPORTANT TO RECOGNIZE THAT LOTTERY EXPENSES AS A PERCENT OF SALES TEND, ON AVERAGE, TO BE RELATIVELY HIGH FOR SMALL STATES. THIS IS BECAUSE SMALL STATES CANNOT SPREAD THEIR OVERHEAD EXPENSES OVER AS LARGE A SALES BASE AS CAN LARGE STATES. FOR THIS REASON, IT IS MOST MEANINGFUL TO COMPARE THE ALLOCATIONS FOR CALIFORNIA PROPOSED IN THE INITIATIVE TO THOSE OF STATES WITH LARGE URBAN POPULATIONS. IT IS ALSO IMPORTANT TO RECOGNIZE THAT STATES WHICH HAVE ONLY RECENTLY IMPLEMENTED LOTTERIES INITIALLY TEND TO HAVE UNUSUALLY HIGH EXPENSES AS A PERCENT OF SALES, BECAUSE OF SIGNIFICANT ONE-TIME START-UP COSTS FOR EQUIPMENT PURCHASES AND THE LIKE.

TABLE 3 INDICATES THAT THE DISTRIBUTION OF LOTTERY PROCEEDS IN MAJOR INDUSTRIAL STATES WITH WELL-ESTABLISHED LOTTERIES AND LARGE URBAN POPULATIONS IS APPROXIMATELY 49 PERCENT FOR PRIZES, 10 PERCENT FOR

TABLE 3

PERCENT DISTRIBUTION OF LOTTERY SALES PROCEEDS IN 1983-84[A]

STATE	PERCENT OF LOTTERY RECEIPTS ALLOCATED TO: PRIZES	ADMINISTRATIVE EXPENSES	PUBLIC PURPOSES
ARIZONA	45%	26%	29%
CONNECTICUT	50	12	38
COLORADO	50	15	35
DELAWARE	47	11	42
ILLINOIS	48	8	44
MAINE	49	23	28
MARYLAND	51	8	40
MASSACHUSETTS	51	12	37
MICHIGAN	50	10	40
NEW HAMESHIRE[B]	48	25	27
NEW JERSEY[B]	50	8	42
NEW YORK	44	13	43
OHIO	48	10	42
PENNSYLVANIA	49	9	42
RHODE ISLAND	50	17	33
VERMONT[B]	28	44	28
WASHINGTON	45	15	40
WASHINGTON, D.C.[B]	48	26	25
UNWEIGHTED AVERAGE FOR ALL LOTTERIES	47%	16%	36%
UNWEIGHTED AVERAGE FOR WELL-ESTABLISHED LOTTERIES IN MAJOR INDUSTRIAL STATES[C]	49%	10%	41%

A. DETAIL MAY NOT ADD TO TOTALS DUE TO ROUNDING. ALL 1983-84 DATA ARE PRELIMINARY ESTIMATES OBTAINED THROUGH WRITTEN QUESTIONNAIRES AND/OR TELEPHONE CONVERSATIONS WITH STATE LOTTERY OFFICIALS.

B. DATA ARE FOR 1982-83; DATA FOR 1983-84 WERE NOT YET COMPILED.

C. INCLUDES THE STATES OF CONNECTICUT, ILLINOIS, MARYLAND, MASSACHUSETTS, MICHIGAN, NEW JERSEY, NEW YORK, OHIO AND PENNSYLVANIA. IF THE THREE WESTERN LOTTERY STATES OF ARIZONA, COLORADO AND WASHINGTON ARE INCLUDED, THE AVERAGE ALLOCATION OF LOTTERY PROCEEDS IS ABOUT 48 PERCENT FOR PRIZES, 12 PERCENT FOR EXPENSES, AND 39 PERCENT FOR PUBLIC PURPOSES.

ADMINISTRATIVE EXPENSES, AND 41 PERCENT FOR PUBLIC PURPOSES. THIS IS QUITE SIMILAR TO THE DISTRIBUTION IMPLIED IN PROPOSITION 37 FOR A FULLY-OPERATIONAL LOTTERY, TAKING INTO ACCOUNT THE FACT THAT PUBLIC EDUCATION WOULD RECEIVE BOTH UNCLAIMED LOTTERY PRIZES AND THE AMOUNT BY WHICH ADMINISTRATIVE EXPENSES FALL BELOW 16 PERCENT OF SALES.

6. STATE REVENUE LOSSES DUE TO THE TAX EXEMPTION ON LOTTERY WINNINGS

YOU HAVE ASKED WHAT OUR ESTIMATE IS OF THE INCOME TAX LOSS WHICH WOULD RESULT FROM THE EXEMPTION OF LOTTERY WINNINGS FROM STATE AND LOCAL TAXES, AS PROVIDED BY PROPOSITION 37.

RESPONSE

THIS QUESTION CAN BE VIEWED FROM SEVERAL DIFFERENT PERSPECTIVES. ONE SUCH PERSPECTIVE INVOLVES THE ISSUE OF THE INCOME TAX LOSS WHICH PROPOSITION 37'S EXEMPTION OF LOTTERY WINNINGS FROM INCOME TAXATION WOULD PRODUCE, RELATIVE TO THE AMOUNT OF TAX REVENUES WHICH WOULD BE COLLECTED IF LOTTERY WINNINGS WERE TAXABLE. THIS REVENUE LOSS WOULD DEPEND PRIMARILY ON TWO FACTORS:

- THE MARGINAL TAX RATES OF LOTTERY PRIZE WINNERS, AND
- THE EXTENT TO WHICH LOTTERY PRIZE WINNERS TAKE STEPS TO OFFSET THEIR LOTTERY-RELATED INCOME GAINS BY THE USE OF VARIOUS TAX SHELTERS.

THE LARGEST STATE PERSONAL INCOME TAX LOSS WOULD OCCUR FROM THIS PERSPECTIVE IF ALL LOTTERY WINNINGS WOULD NORMALLY BE REPORTED AS TAXABLE LOTTERY INCOME AND APPEARED ON TAX RETURNS SUBJECT TO THE STATE'S MAXIMUM MARGINAL TAX RATE OF 11 PERCENT. BASED UPON OUR ESTIMATE OF LOTTERY TICKET SALES UNDER A FULLY-OPERATIONAL LOTTERY ($1,25 BILLION ANNUALLY), THE

MAXIMUM STATE INCOME TAX REVENUE LOSS WOULD BE ABOUT $70 MILLION ANNUALLY. HOWEVER, THE ACTUAL LOSS WOULD DOUBTLESS BE MUCH LESS THAN THIS AMOUNT, SINCE NOT ALL LOTTERY PRIZE MONEY WOULD BE SUBJECT TO AN 11 PERCENT TAX RATE. ONE REASON FOR THIS IS THAT MOST PRIZES IN INSTANT LOTTERY GAMES ARE RELATIVELY SMALL (UNDER $50), AND THEREFORE INCAPABLE OF AUTOMATICALLY PLACING A TAXPAYER INTO THE STATE'S MAXIMIM TAX BRACKET. IT IS ALSO IMPORTANT TO NOTE THAT IF CALIFORNIA IMPLEMENTED LOTTO-TYPE LOTTERY GAMES WITH MULTI-MILLION DOLLAR PRIZES, THE LOTTERY COMMISSION MIGHT DECIDE TO PAY THESE PRIZES OUT OVER A MULTI-YEAR PERIOD AS IS DONE IN OTHER STATES, IN WHICH CASE THE TAXES DUE ON THE PRIZES WOULD NOT BE COLLECTED IMMEDIATELY BUT RATHER WOULD BE SPREAD OVER TIME.

A SECOND WAY TO VIEW THE QUESTION OF LOST INCOME TAX REVENUES IS TO ASK HOW TOTAL STATE INCOME TAX REVENUES IN THE ABSENCE OF A LOTTERY ALTOGETHER WOULD COMPARE WITH TOTAL STATE INCOME TAXES IF PROPOSITION 37 WERE APPROVED. IN THIS CASE, TOO, THERE WOULD BE SOME UNKNOWN BUT PROBABLE LOSS IN STATE INCOME TAX REVENUES DUE TO PROPOSITION 37, ASSUMING THAT THE PRIZE-SHARE OF LOTTERY TICKET SALES WOULD, IN THE ABSENCE OF A LOTTERY, HAVE BEEN SPENT ON GOODS AND/OR SERVICES WHOSE PRODUCTION WOULD HAVE CONCURRENTLY GENERATED SOME TYPE OF TAXABLE INCOME. HOWEVER, BECAUSE WE HAVE NO WAY AT PRESENT OF KNOWING THE EXTENT TO WHICH LOTTERY TICKET SALES WOULD COME AT THE EXPENSE OF ITEMS WHOSE PRODUCTION CONCURRENTLY GENERATES TAXABLE INCOME, WE CANNOT ESTIMATE WHAT THE ASSOCIATED INCOME TAX REVENUE LOSS MIGHT BE.

7. THE EFFECT OF A LOTTERY ON PARIMUTUAL WAGERING REVENUES

YOU HAVE ASKED TO WHAT EXTENT, IF ANY, WE BELIEVE THAT THE PROPOSED LOTTERY WOULD REDUCE STATE REVENUES FROM PARIMUTUAL WAGERING ON HORSE RACING.

RESPONSE

WE BELIEVE THAT MOST IF NOT ALL FORMS OF GAMBLING HAVE AT LEAST SOME DEGREE OF SUBSTITUTABILITY FOR ONE ANOTHER, AND THEREFORE THAT ESTABLISHMENT OF A LOTTERY COULD CAUSE SOME LOSS IN STATE PARIMUTUAL HORSE RACING REVENUES. HOWEVER, BECAUSE HORSE RACING IS NOT MERELY A WAGERING ACTIVITY BUT ALSO IS A POPULAR SPECTATOR SPORT IN ITS OWN RIGHT, AND BECAUSE HORSE RACING WAGERING CAN INVOLVE CERTAIN HANDICAPPING SKILLS WHICH MANY BETTORS ENJOY PURSUING, WE WOULD BE SURPRISED IF THE NEGATIVE EFFECT OF A LOTTERY ON HORSE RACING WAGERING WAS PARTICULARLY SIGNIFICANT.

THE ACTUAL EMPIRICAL EVIDENCE ON THE WAY IN WHICH LOTTERY WAGERING AND PARIMUTUAL HORSE RACING WAGERING AFFECT ONE ANOTHER IS SKETCHY. ONE RECENT STUDY ON GAMBLING BEHAVIOR IN NEW JERSEY FOUND THAT THE PORTION OF LOTTERY PARTICIPANTS WHO ALSO WERE HORSE RACING PARTICIPANTS GENERALLY TENDED TO LIE BETWEEN 20 PERCENT AND 25 PERCENT, DEPENDING ON THE TYPE OF LOTTERY GAME, INDICATING THAT THERE WAS INDEED SOME POTENTIAL FOR "CROSS-OVER" BETTING BETWEEN THE TWO ACTIVITIES; HOWEVER, THE SPECIFIC EFFECT OF LOTTERY BETTING AND HORSE RACING BETTING ON ONE ANOTHER WAS NOT EXAMINED. IN OUR OWN STATISTICAL ANALYSIS OF WHY PER CAPITA LOTTERY SALES

VARY AMONGST STATES, WE FOUND THAT THE PRESENCE OF ALTERNATIVE LEGAL GAMBLING ACTIVITIES, SUCH AS PARIMUTUAL WAGERING, DOES IN FACT REDUCE LOTTERY SALES; HOWEVER, THIS EFFECT WAS NOT ESPECIALLY STRONG. GIVEN THIS SKETCHY EMPIRICAL EVIDENCE, WE RECENTLY CONTACTED THE STATE HORSE RACING BOARDS IN EACH OF THE FOURTEEN LOTTERY STATES WHICH ALSO PERMIT PARIMUTUAL WAGERING ON HORSE RACES. ELEVEN OF THE FOURTEEN STATES REPORTED THAT THEY FELT THEIR LOTTERY HAD EITHER NO EFFECT OR ONLY A NEGLIGIBLE EFFECT ON THEIR PARIMUTUAL WAGERING; THE REMAINING THREE STATES WOULD NOT RULE OUT THE POSSIBILITY THAT THEIR LOTTERY MIGHT HAVE HAD SOME EFFECT, BUT HAD NO SPECIFIC DATA TO SUPPORT THIS CONCLUSION AND DID NOT BELIEVE THAT THE EFFECT WAS PARTICULARLY SIGNIFICANT. THUS, WE ARE NOT AWARE OF ANY "HARD" EVIDENCE THAT THE EXISTENCE OF LOTTERIES NOTICEABLY REDUCES PARIMUTUAL HORSE RACING REVENUES.

8. INDIRECT FISCAL EFFECTS

YOU HAVE ASKED WHETHER ANY INDIRECT FISCAL EFFECTS MIGHT RESULT FROM A STATE LOTTERY, INCLUDING THE POSSIBLE LOSS OF SALES TAX REVENUES IF THE PURCHASE OF LOTTERY TICKETS DIVERTS DISPOSABLE INCOME FROM BEING SPENT ON TAXABLE GOODS.

RESPONSE

THE ANSWER TO THIS QUESTION IS "YES"--THERE UNDOUBTEDLY WOULD BE CERTAIN INDIRECT FISCAL EFFECTS RESULTING FROM THE ESTABLISHMENT OF A STATE LOTTERY. INDIRECT FISCAL EFFECTS ARE USUALLY AN INEVITABLE CONSEQUENCE OF

ANY TYPE OF MAJOR CHANGE IN THE PRODUCTION AND CONSUMPTION OF GOODS AND SERVICES IN AN ECONOMY, ESPECIALLY WHEN, AS IS ESSENTIALLY THE CASE WITH PROPOSITION 37, AN ENTIRELY "NEW" COMMODITY IS CREATED.

IN THE CASE OF A STATE LOTTERY, THERE CERTAINLY COULD BE SOME LOSS IN SALES TAX REVENUES TO THE EXTENT THAT SOME PORTION OF THE WELL-OVER $1 BILLION PROJECTED TO BE SPENT ANNUALLY ON LOTTERY TICKETS WOULD OTHERWISE HAVE BEEN SPENT DIRECTLY ON TAXABLE GOODS. OF COURSE, TO THE EXTENT THAT THE LOTTERY RESULTS IN INCREASED EXPENDITURES ON LOTTERY EQUIPMENT, EDUCATIONAL SUPPLIES AND OTHER SUCH ITEMS, THERE COULD ALSO BE CERTAIN POSITIVE SIDE-EFFECTS OF THE LOTTERY ON SALES TAX REVENUES.

OTHER TYPES OF EFFECTS WHICH THE PROPOSED STATE LOTTERY MIGHT PRODUCE COULD INCLUDE CHANGES IN THE DISTRIBUTION OF AFTER-TAX INCOMES OF INDIVIDUALS (THIS WOULD DEPEND ON THE EXTENT THAT LOTTERY PARTICIPATION WOULD VARY AMONGST INCOME GROUPS), CHANGES IN THE PATTERN OF INCOME FLOWS BETWEEN CALIFORNIA AND OTHER STATES (THIS WOULD DEPEND ON SUCH FACTORS AS WHERE LOTTERY EQUIPMENT WAS MANUFACTURED AND TO WHOM LOTTERY OPERATING PROFITS ACCRUED), AND CHANGES IN EMPLOYMENT IN THOSE INDUSTRIES WHOSE OUTPUT MIGHT BE CHANGED BECAUSE OF A REDIRECTION OF CONSUMER SPENDING INTO LOTTERY WAGERING.