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Leasing the Lottery

Many states from New York to Indiana have explored the possibility of leasing their state lotteries. This has stirred up long-standing arguments about state-supported gambling and privatization. Central to these arguments include issues such as: how privatization will affect the marketing of the lotteries; demographics of lottery players; and, whether it is in the public interest to have more people playing the state lotteries.

Who Plays the Lottery and Why

There are two basic motivations for playing the lottery—pleasure and money. In 1986, lottery players in California were asked if they played more for fun or money, the results were evenly divided. However, when income was taken into account, those making \$30,000 or less are 25 percent more likely to cite money as their motivation. The reverse was true for those at upper incomes.¹

Roughly one third of adults in lottery states play at least once a week, nonetheless, a small percentage of players account for a large percentage of lottery sales each week. The most active 10 percent of players account for approximately 50 percent of lottery wagers.²

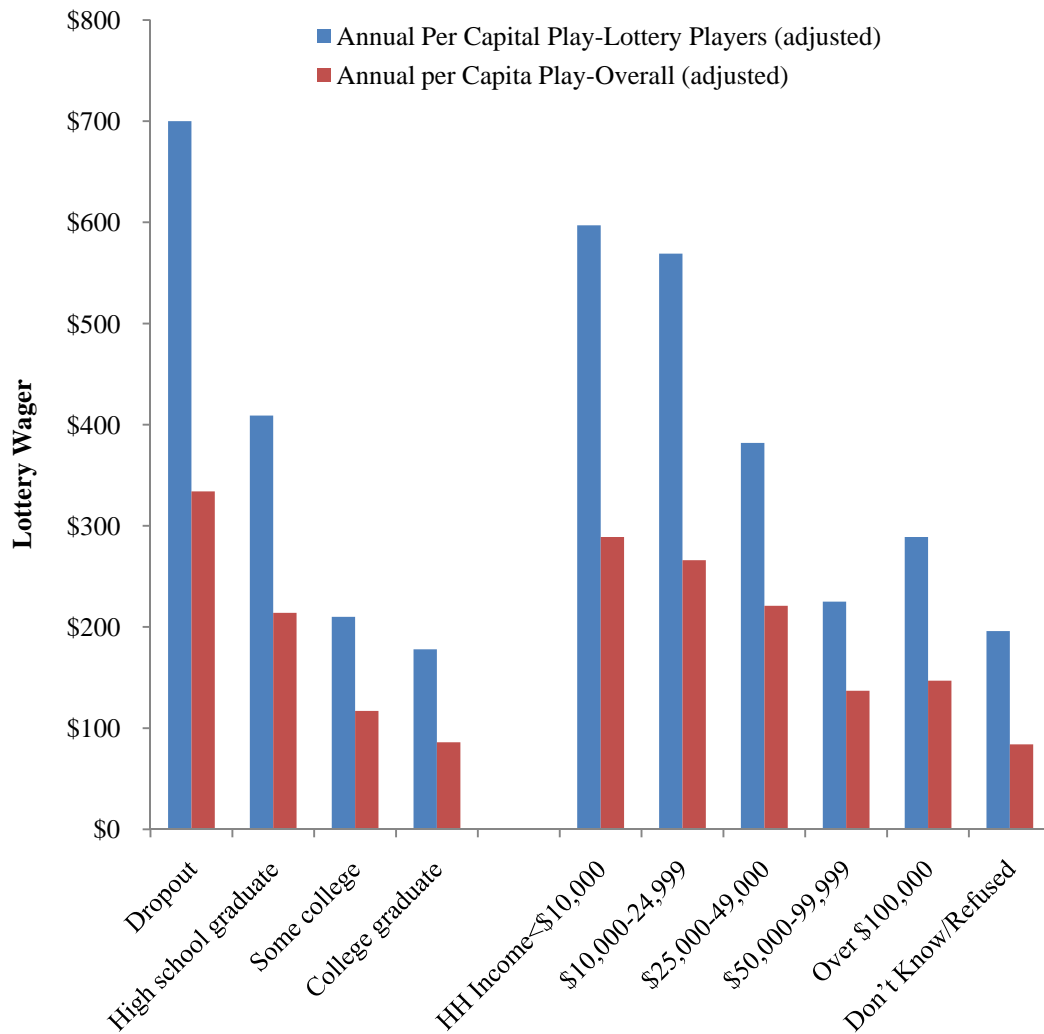
There are some clear demographic patterns in terms of who plays the lottery. The frequency of playing the lottery falls as levels of education increase, and is highest in adults' middle years, approximately 25 to 65. Contrary to conventional wisdom the data examined does not show a correlation between lottery play and household income over the broad middle range or \$10,000 to \$60,000 in yearly income in 1986.³

The Report to the National Gambling Impact Study Commission, a U.S. government study published in 1999, summarized the demographics of lottery players from survey data published the same year. Their findings are reproduced in Figure 1 below.

¹ Clotfelter, C. T, and Cook, P.J., "On the Economics of State Lotteries," *The Journal of Economic Perspectives* (Fall 1990), pp.105-119.

² Clotfelter and Cook, "On the Economics of State Lotteries."

³ Clotfelter and Cook, "On the Economics of State Lotteries."



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As indicated in Figure 1, there are some clear patterns in terms of who plays the lottery. Lottery play falls with level of education and income. Additionally, the frequency of play is highest in adults' middle years, approximately 25 to 65.⁵

Marketing the Lottery

To help raise revenues, lotteries engage in heavy marketing campaigns. Concerns have arisen regarding the possibility of marketing campaigns preying on low-income citizens and potential dishonesty concerning odds of winning. Like other marketing entities, lotteries analyze their

⁴ Clotfelter and Cook, "On the Economics of State Lotteries."

⁵ Clotfelter and Cook, "On the Economics of State Lotteries."

customer bases before designing a campaign.⁶ Some state lotteries have advertising codes of conduct. The Indiana code includes (in 1999) the following:

- Commercials will treat the talent, players and customers with class and dignity.
- No children will be used in advertising nor will advertising be directed toward them.
- The Lottery will not be promoted as an alternative to work and terms like checking account, savings account and references to financial institutions will be avoided.
- Ads will be careful not to sell the dream of a “way out” of their current financial situation or flash big signs of extreme wealth.
- Odds of winning will be clearly stated in advertising where appropriate.⁷

One main criticism of lottery marketing is that it legitimizes gambling and makes it seem benign in the eyes of the citizenry. Clotfelter et al. (1999) argue that the message of lottery advertising is subversive, because it tells people that success is dependent on picking the right number. They argue that in the end this “education” may actually decrease economic growth by eroding the propensity to work, save, and invest in education. In this view, the lottery is an entity designed entirely for short-term gains.

Another issue raised by critics of lottery marketing is that increased lottery marketing, especially if states lease the lottery to private companies, could actually result in a decrease in state revenues. The logic behind this argument is as follows: people who play the lottery come disproportionately from lower socioeconomic status and if they are induced to spend their money on lottery tickets by marketing campaigns, then they will spend less money on other things that the state taxes, such as clothes, alcohol, cigarettes and other goods.⁸

Government Oversight of Privatized Lotteries

While states may be trying to relieve themselves of responsibilities associated with running lotteries by leasing them, even leased lotteries will still require governmental oversight. States will have to monitor lotteries to make sure that they abide by various parameters as set by the states, and actually pay what they promised to the states. While there is no data on how much that costs for a state, the UK National Lottery provides some possible insight into expected oversight costs. The National Lottery Commission oversees the UK National Lottery by monitoring the company that runs the lottery and taking bids for a license every seven years (see below). The net operating cost of the National Lottery Commission for financial year 2006/07 was £11,427,000.⁹ This means that in spite of a having a semi-privatized lottery the government was still spending over £11 million (or \$21,369,169) on lottery operations.

⁶ Clotfelter, Charles T., Cook, Philip J., Edell, Julie A., Moore, Marian, April 23, 1999, “State lotteries at the turn of the century: Report to the national gambling impact study commission.”

⁷ Clotfelter and Cook, “On the Economics of State Lotteries.”

⁸ Jonathon Kaplan, “Gambling on the future: Should California privatize the state lottery?” *California Budget Project* (June 2007), retrieved January 30, 2007 from http://www.cbp.org/pdfs/2007/0706_bb_lottery.pdf.

⁹ National Lottery Commission, *Regulating the National lottery: Annual reports and accounts 2006/2007*, retrieved February 11, 2008 from http://www.natlotcomm.gov.uk/UploadDocs/Contents/Documents/NLC%20report%2007_Web%20final.pdf.

Lottery as Education Funding

Currently of 42 states that have lotteries, 23 earmark some or all of their profits for education. Though the money may be earmarked for education, lottery proceeds do not contribute much to education funding. According to an analysis reported in *The New York Times* state lottery profits account for anywhere from less than 1 percent to 5.3 percent of total education funding.¹⁰

Georgia, Illinois, Michigan, Missouri, New Mexico, New York, Ohio, Texas, Vermont, and Virginia put 100 percent of their lottery profits into education funds, so theoretically Vermont put \$23 million into the education fund from lottery profits last year.¹¹ Most states put about 30 percent of their total lottery revenue towards either education or a general fund, depending on how state law divides the money. Here are a few examples of how states allocate their lottery profits:

- New Hampshire puts about 30 percent of lottery revenue towards education every year. Last year \$79,043,331 went towards education, which was 29.8 percent of the total revenue.¹²
- Connecticut puts 29 percent of lottery revenue into the general fund, which is divided among 17 state services. Last year \$41,655,000 went to the Department of Education, which was 14.9 percent of the 29 percent that went to services.¹³
- Illinois put 33 percent of its lottery revenue to the Common School Fund in FY 2007. This was \$622 million last year.¹⁴
- California law mandates that at least 34 percent of total lottery sales be put toward education, and last year 34.73 percent or \$1,206,147,082 actually went to education.¹⁵
- In Texas 27 percent of lottery revenue goes to the Foundation School Fund, and in 2007 2 percent of lottery revenue (unclaimed prizes) went to other state programs. Over a billion dollars went to the School Fund in FY2007.¹⁶

Several studies examine the practice of earmarking lottery money for education spending. In a 2005 study, Evans and Zhang determined that on average 50 to 70 cents of every lottery dollar earmarked towards education makes it to local school districts. In states where lottery money is simply deposited in a general fund, every dollar deposited in the general fund resulted in 30 cents

¹⁰ Stodghill, Ron & Nixon, Ron, "For Schools, Lottery Payoffs Fall Short of Promises," *The New York Times*, October 7, 2007

¹¹ Coeyman, Majorie. (2003, July 15), "Lottery isn't always a boon to schools," *The Christian Science Monitor*, Retrieved February 25, 2008 from <http://www.csmonitor.com/2003/0715/p14s01-lepr.htm>

¹² New Hampshire Lottery Commission, retrieved February 25, 2008 from <http://www.nhlottery.org/supporting-education/yearly.asp>

¹³ Connecticut Lottery, "Where the money goes," retrieved February 25, 2008 from <http://www.ctlottery.org/proceeds.htm>

¹⁴ Illinois Lottery, "Proceeds," retrieved February 25, 2008 from <http://www.illinoislottery.com/subsections/news01.htm>

¹⁵ California Lottery, "California Lottery and You: California Lottery Report to the Public Fiscal Year 2006/2007," retrieved February 25, 2008 from <http://www.calottery.com/NR/rdonlyres/7F476E30-187B-429F-B566-5027C6444C9B/0/LotteryAR2007English.pdf>

¹⁶ Texas Lottery, "Supporting education," retrieved February 25, 2008 from http://www.txlottery.org/export/sites/default/Supporting_Education/

spent on education. This means that earmarking has the result of increasing education spending, despite the fact that between 30 and 50 cents of every dollar earmarked is diverted away from education.¹⁷

Throughout the Nation and Abroad

Vermont

Vermont Governor Jim Douglas recently proposed leasing the Vermont state lottery to private investors. He proposed charging \$50 million up front plus guaranteed annual payments of \$23 million¹⁸, which is how much the lottery current earns in annual profit.¹⁹ The basic policy question is whether the lease is a good long-term investment for the state, or simply a one-time benefit.

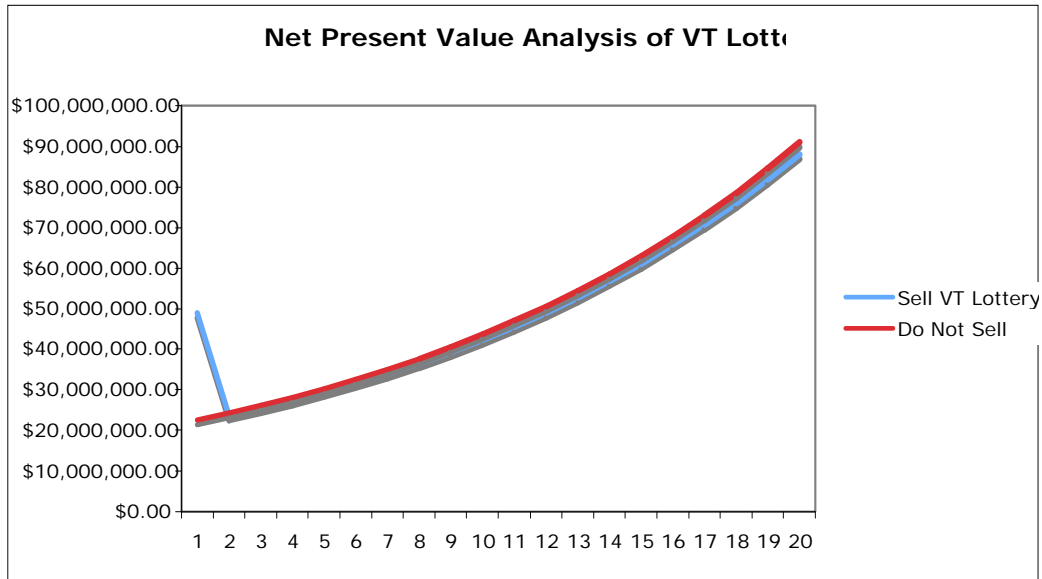
If we look at the Vermont lottery as an investment, we can measure how the investment will do over time. The most widely used method for measuring investments is the Net Present Value (NPV) analysis. This analysis looks at what something is worth today based on projections of future values. To find the present day value you need to be able to discount a future investment by dividing the future value by the opportunity cost of investing the money elsewhere. For most instances the current Treasury-Bill rate is used because it is an investment that has no risk of loss. The current T-Bill rate in this analysis was 2.2 percent. We also assumed that profits for the Vermont lottery would increase 10 percent a year on average for the next 20 years (which is a little less than the S&P average for growth).

Using the NPV analysis we were able to find the price break-even point at which Vermont would earn the same amount of money over a twenty year period regardless of whether the lottery was sold or not. If Vermont were to sell the lottery for \$50 million upfront, it would have to receive over \$24.5 million annually (with an increase of 10 percent a year) for 20 years. If the sale was made in this way the lottery would provide the same financial benefit for Vermont as continuing to operate the lottery publicly assuming \$23 million in lottery profits a year and continued to growth of 10 percent a year for the next 20 years. (See chart on following page) This analysis provides numbers similar to the Governor's proposal.

¹⁷ William N. Evans and Zhang, Ping, "The Impact of Earmarked Lottery Revenue on State Educational Expenditures," March 5, 2005, retrieved February 25, 2008 from http://www.bsos.umd.edu/econ/evans/wpapers/evans_zhang_earmark_lottery.pdf

¹⁸ Jim Douglas, "Governor's Budget Address: Achieving Prosperity through Affordability, January 22, 2007, retrieved February 13, 2008 from http://governor.vermont.gov/speeches/Budget_Address_1-22-08.pdf.

¹⁹ Dave Gram, (2008. January 21), "Vermont, Other States Weigh Privately Run State Lottery," *The Boston Globe*, retrieved February 13, 2008 from http://www.boston.com/news/local/connecticut/articles/2008/01/21/vermont_other_states_weigh_privately_run_state_lottery/.



New York

New York receives \$2 billion yearly from state lottery revenue, making it the largest state lottery. New York allocates this money to fund education. In January 2008 Gov. Eliot Spitzer announced a proposal to lease the lottery though the method of doing so has yet to be determined. One proposal is to sell the lottery for \$45 billion upfront and place this money in a trust fund. The interest from the fund would continue to be used to help pay for education. Other possibilities include leasing the lottery but retaining some part of the lottery's revenue with a smaller initial payout.²⁰

Texas

Texas Governor Rick Perry proposed a plan to sell the state lottery for at least \$14 billion. The money would be divided into three trusts. The three trusts include public education, cancer research, and a new health insurance program.²¹

California

In early 2007, Governor Arnold Schwarzenegger proposed selling the lottery to private investors, claiming that it could be worth as much as \$37 billion. Unsolicited proposals by investment bankers have put the number somewhere between \$13 and \$18 billion, so there is clearly room

²⁰ German, Erik, "Is Taking State Lottery Private Worth the Gamble?" *NewsDay*. January 20, 2008, retrieved February 6, 2008 from www.newsday.com.

²¹ Shannon, Kelley, "Gov. Proposes Selling Texas Lottery," *The Washington Post*, February 6, 2007, retrieved February 6, 2008 from www.washingtonpost.com.

for argument.²² In 2006, the state lottery had \$3.6 billion in sales, which amounted to \$1.3 billion in profit.²³ Governor Schwarzenegger believes that this figure is much lower than it should be. According to the *Sacramento Bee*, Californians spend on average \$81 per year on the lottery, while the national average is \$158.²⁴ The state also has fewer lottery retail locations per person than all but two lottery states.²⁵ If California could get its lottery sales up to the national average then there would be billions more dollars for education and healthcare.

Indiana

In late 2006, Governor Mitch Daniels proposed leasing the Hoosier Lottery to a private company in exchange for at least \$2 billion up front to fund education programs and \$200 million annually to the state, and possibly a profit sharing scheme. The year before Daniels' proposal the Hoosier Lottery brought in about \$200 million in profits.²⁶ The proposal has been held up in the Indiana House of Representatives, and in November of 2007 Governor Daniels formally dropped the proposal, although he said that one company was willing to pay \$1 billion up front and \$200 million a year for a thirty year lease.²⁷

Illinois

In early 2007, Illinois attempted to lease its state lottery. The state was proposing terms that were closer to a sale than a lease: it wanted \$10 billion up front, in exchange for which investors would get all of the profits from the lottery for the next 75 years. This is an extreme proposal, as the state made about \$630 million in *profits* in 2006, and could potentially make a lot more than \$10 billion over the next 75 years. Although Governor Blagojevich would invest some of the money for long term education funding, it seems logical that the state would actually lose money on the deal. If lottery sales remained steady over the next 75 years, the state would theoretically earn \$47.25 billion in profits, without adjusting for inflation, which makes the \$10 billion up front seem like a very bad deal. According to state officials, the leased lottery would still have to abide by state advertising and sales laws.²⁸ The legislature eventually voted down this proposal, creating a bill making it illegal for any state official to sell or lease any part of the state lottery.

²² Jonathan Kaplan, "Gambling on the future: Should California Privatize the State Lottery?" *California Budget Project*, retrieved February 11, 2008

from http://www.natlotcomm.gov.uk/UploadDocs/Contents/Documents/NLC%20report%2007_Web%20final.pdf.

²³ Judy Lin, "A push to make lottery private," *The Sacramento Bee*, May 11, 2007, p. A1, retrieved January 30, 2008 from <http://www.sacbee.com/111/story/175750.html>.

²⁴ Judy Lin, "A push to make lottery private."

²⁵ Jonathan Kaplan, "Gambling on the future: Should California Privatize the State Lottery?"

²⁶ Duhigg, Charles and Anderson, Jenny, "Illinois Is Putting Lottery on Block for Quick Payoff," *The New York Times* January 23, 2007, retrieved February 6, 2008 from <http://www.nytimes.com/2007/01/23/business/23lotto.html>

²⁷ *TheIndyChannel* (Indiana Local News), December 14, 2006, "Daniels Touts Lottery Lease Plan"

TheIndyChannel.com Retrieved February 6, 2008 from <http://www.theindychannel.com/news/10532035/detail.html>

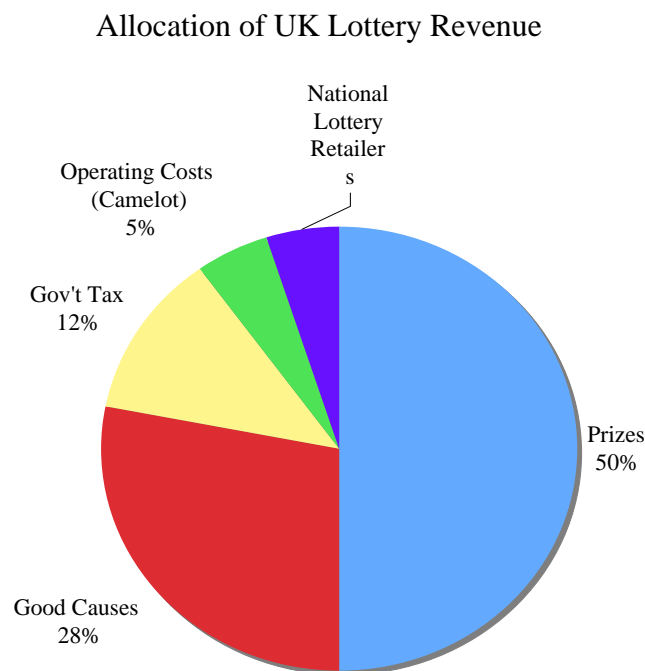
²⁸ Lottery Post Staff, "Indiana Governor Drops Lottery Privatization," November 23, 2007, Lotterypost.com, retrieved February 6, 2008 from <http://www.lotterypost.com/news/166489>

The United Kingdom

In 1994, Great Britain launched their National Lottery, which is considered semi-privatized. The National Lottery Commission, a government agency, licenses the right to operate the lottery to a private firm for a seven year period. Private companies submit proposals to the commission, which awards the license based on the following criteria:²⁹

- “Ultimately, the license will be awarded to the bidder that is able to support the greatest forecast returns to good causes whilst demonstrating that they can meet other required standards;
- “The next operator will need to demonstrate it is able to manage the transition to the third license transition without any interruption of service”

The lottery is leased for short periods with a lot of oversight, a model very different from the proposals of various US governors. A private group called Camelot has won all three bids for the license since the creation of the lottery in 1994. The following is a rough breakdown, according to the National Lottery Commission, of where lottery sales money goes:³⁰



²⁹ Moore, Peter G., “The Development of the UK National Lottery, *Journal of the Royal Statistical Society, Series A* (Statistics in Society), Vol. 160, No. 2, 1997, pp. 169-185, retrieved from www.JSTOR.org on January 30, 2008.

³⁰ National Lottery Commission, (2008), retrieved from the UK National Lottery Commission website at <http://www.natlotcomm.gov.uk/CLIENT/index.asp>

According to a recent article in *The Independent*, the Camelot Group is currently going to fall about £1 billion short of its projected funding for good causes. Sales have remained steady for the past few years, but have not been improving enough to adjust for inflation.³¹

According to the National Lottery Commission, 70 percent of British adults play the lottery on a regular basis, which means that the privatized lottery has been highly successful at increasing lottery sales.³² According to a 2003 survey, 47 percent of respondents believe that they play the lottery now more than they did when it first came out. A 1998 survey of 12-15 year olds in England and Wales found that the introduction of new forms of gambling, including the National Lottery, had increased the amount of underage gambling in the United Kingdom. The general success rate for underage purchases of Lottery materials was about 56 percent.³³

This report prepared by Daniel Robert Woodward, Kensington Moore and Derek Stewart under the supervision of Professor Anthony Gierzynski on April 16, 2008.

Disclaimer: This report has been compiled by undergraduate students at the University of Vermont under the supervision of Professor Anthony Gierzynski. The material contained in the report does not reflect the official policy of the University of Vermont.

³¹ Johnson, Andrew, Mesure, Susie, February 3, 2008, "Camelot and its finances: Lottery Fund for Good Causes is Facing 1bn Shortfall," *The Independent*, retrieved February 11, 2008 from <http://www.independent.co.uk/news/uk/this-britain/camelot-and-its-finances-lottery-fund-for-good-causes-is-facing-1631bn-shortfall-777540.html>

³² National Lottery Commission, (2008) Retrieved from the UK National Lottery Commission website at <http://www.natlotcomm.gov.uk/CLIENT/content.ASP?ContentId=25>

³³ Fisher, Sue, "Gambling and problem gambling among young people in England and Wales." 1998, report commissioned by the National Lottery Commission, retrieved February 11, 2008 from <http://www.nationallotterycommission.gov.uk/UploadDocs/Contents/Documents/Gambling%20and%20problem%20gambling%20among%20young%20people%20in%20England%20and%20Wales.pdf>