John LOCKE FOUNDATION

SPOTLIGHT

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The Miseducation Lottery

Public Presented With Inflated Revenues, Benefits

Summary: Gov. Mike Easley's proposed budget for FY 2002-03 includes $250 million in revenue from a state-run lottery that has yet to be enacted. Among many legitimate objections to the administration's idea are that expected net revenue is inflated by between 37 percent and 62 percent — creating a hole in the budget of as much as $96 million — and that the administrative costs of the lottery tax exceed both the cost of alternative taxes and any revenue "loss" to out-of-state lotteries.

According to the governor's office, his 2002-03 budget anticipates that North Carolina will begin operation of a state-run lottery by January 2003. That means that Easley's budgeted amount of $250 million in estimated revenues reflects the assumption that a full year of lottery operation would generate approximately $1.5 billion in ticket sales, or $500 million in tax revenue to the state.

This is a gross exaggeration of the tax revenue North Carolina could expect to raise from a lottery. For example, South Carolina sold $274.1 million in tickets in the first 20 weeks of its lottery. If this sales pace were to be sustained (it is more likely that revenues will drop off somewhat from the opening weeks), the South Carolina lottery would sell $713 million in tickets, generating about $240 million in state revenues.

Adjusting these numbers to reflect our state's larger population and the lower probability of cross-border sales, North Carolina could expect about $1.2 billion in gross sales if its lottery experienced a similar opening year, or nearly $300 million lower than Easley's estimate. Moreover, the governor made no adjustment for offsetting losses in sales and other tax revenues as lottery players purchase tickets instead of other taxable goods. Doing so results in estimated revenue of $366 million for the first full year of a North Carolina lottery, far below the governor's $500 million estimate.

Other projections of lottery revenue are lower still. For example, last year the John Locke Foundation constructed a model to estimate North Carolina revenue based upon the performance of state lotteries in eight Southern and border states. Rather than basing the projection simply on population, as the Easley administration does, the JLF model used state personal income to establish a more relevant base for comparison. Updating the model with the latest income data, we now project annual

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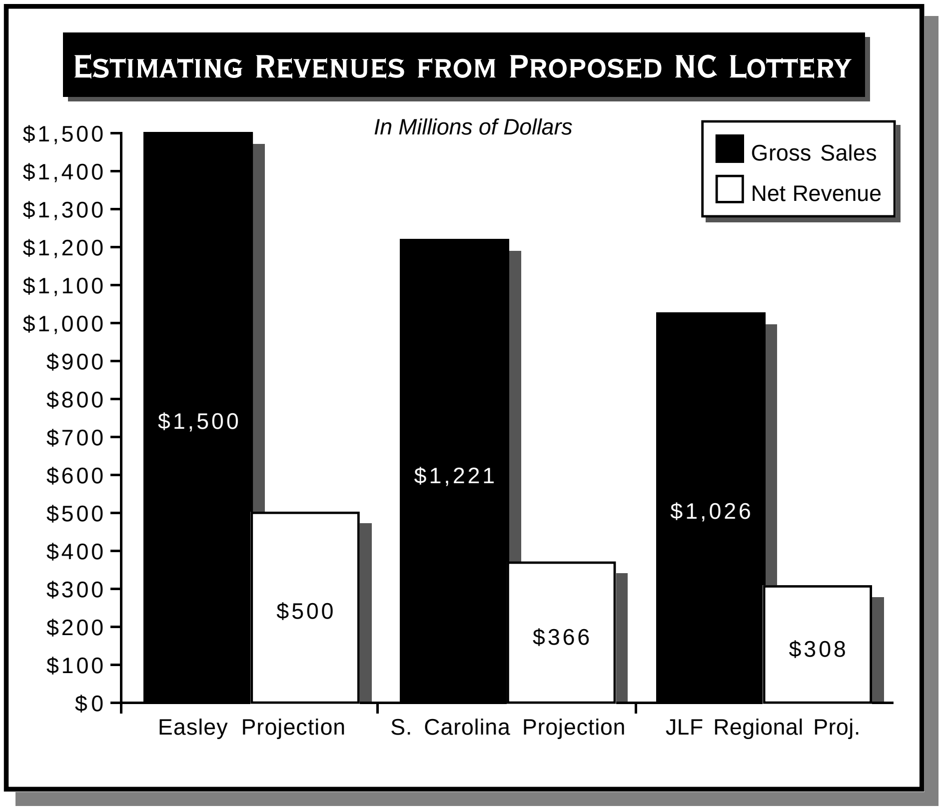
sales of approximately $1 billion, with net revenues barely exceeding $300 million. Based on these two projections, Easley's budget appears to inflate likely lottery revenues by between 37 percent and 64 percent. In the worst-case scenario, the plan would leave a $96 million deficit in FY 2002-03. This creates the risk that, later in the fiscal year, the state may be forced to make sudden budget cuts — likely affecting the very educational programs the lottery is supposed to enhance.



An Inefficient Tax

Although proponents argue that a lottery is an alternative to a tax increase, it is *itself* a new tax — a 33 percent tax applied on all gross lottery sales in the state. As a source of state revenue, a state lottery is an extremely inefficient tax. The $164 million that would be incurred in administrative costs should be measured against the $308 million in usable revenue to the state. In other words, it would cost 53 cents to raise every dollar of a lottery tax.

Using the total budget of the N.C. Department of Revenue, which was $75 million in FY 2001, as an estimate of the administrative costs associated with raising state tax revenues, the average tax dollar costs under one cent to collect. In other words, it would cost more than 50 times the amount to raise a dollar of tax revenue through the use of a lottery than it does through the use of the existing tax code. Even if part of a lottery's administrative cost were attributed to "entertainment," as represented by prizes awarded, such an allocation would reduce the cost per state dollar raised to about 20 cents — still more than 20 times the cost of raising a dollar through the existing tax structure.

Net State Revenues From NC Lottery Players

(Estimated for Virginia and Georgia, Projected for SC based on 20 weeks of sales)

Lottery State	Gross Sales to NC Players	Prizes Awarded to NC Players	Allocation of Administration	Net Revenues From NC Players
Virginia	$98,450,344	$54,147,689	$11,814,041	$32,488,614
Georgia	$10,534,717	$5,727,726	$1,320,000	$3,486,991
Subtotal	$108,985,061	$59,875,415	$13,134,041	$35,975,605
S. Carolina	$106,899,000	$58,473,753	$13,148,577	$35,276,670
TOTAL	$215,884,061	$118,349,168	$26,282,618	**$71,252,275**

Projected Administrative Cost of NC Lottery $164,253,739
Projected Fee to Out-of-State Private Contractor $51,329,310

The Non-Issue of Out-of-State Lotteries

Another implication of the lottery's high administrative cost is that it would far exceed the supposed "revenue loss" to out-of-state lotteries. As the nearby table demonstrates, Virginia and Georgia collect approximately $36 million in state revenue from North Carolinians playing their lotteries (some inflate the number by mistakenly assuming that the entire amount of ticket sales to North Carolinians flows into other states' coffers). Based on current experience, we project that the South Carolina lottery might end up pocketing about $35 million in revenue from North Carolina players. This total revenue "outflow" is less than half the $164 million in administrative cost that a North Carolina lottery would require. Indeed, North Carolina would probably pay an out-of-state contractor an annual fee that would be almost three-quarters of the revenues currently flowing to other state lotteries. Thus it would be irrational to set up a lottery just to reclaim dollars now flowing to out-of-state lotteries. It would cost the equivalent of $2.30 to "save" every $1.00 spent out-of-state.

Gov. Easley proposes to create an "education lottery." But given the exaggerations and inaccuracies in the governor's plan, and in its presentation to the public, a more appropriate name might be a "miseducation lottery."

— John Hood, President