

## DON'T BET ON IT

### *A state lottery would not be an alternative to taxes*

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Summary: Some policymakers and supporters of a proposed government lottery in North Carolina argue that it would be a welcome alternative to raising state taxes to fund education or other services. But there is no evidence to suggest that politicians in lottery states use the proceeds to reduce other taxes. They just allow state budgets to grow. Also, properly understood, a state-run lottery *does* increase taxes — it creates a government gambling monopoly and then levies a steep tax paid by those who buy lottery tickets and receive lottery revenues.

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**W**ith North Carolina facing a fifth-straight year of projected fiscal deficits at the beginning of a legislative session, many lawmakers are trying to find a way to close the gap that involves the least amount of political pain. Some believe that the state's General Fund budget, while allowed to grow by nearly \$1 billion in the proposed 2005-06 budget of Gov. Mike Easley, has little real room for fiscal savings without inflicting serious harm on important state services. Others believe that with \$1 billion tax increases in three of the past four fiscal years, North Carolina taxpayers are unlikely to appreciate Easley's proposal to use \$741 million in higher sales, income, and other taxes to balance the coming year's budget.

Is there an alternative? Some legislators apparently think so. They believe that the governor's call for a state-run lottery might be a way to head off tax increases that they find economically unwise and politically dangerous. But this conclusion is premature. State lotteries have not proven themselves to be alternatives to state taxes — and, understood correctly, these lottery structures actually impose stiff new taxes on many state residents.

#### ***Lotteries and General Tax Trends***

The theory behind this "fiscal conservative" argument for government lotteries is that they offer a "voluntary" way to pay for new spending that allows the tax burden on the general public to remain at the current level, or perhaps even to decrease. Testing this theory means comparing the fiscal trends in states with government lotteries to those without lotteries.

Using estimates from the Washington-based Tax Foundation of state and local taxes as a percentage of personal income, we compared the average tax burden in the 38 states with lotteries in place as of 2003 to the tax burden in the 12 states without them

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(North Dakota and Tennessee added state lotteries in 2004). The average tax burden in the lottery states was 10 percent of personal income, compared to an average of 9.5 percent in the non-lottery states.

More to the point, we tracked these tax burdens over 20 years. If lotteries generated revenues sufficient to convince politicians that they need not raise generally applied taxes (and can even cut them) when budgets get tight, then this effect should be detectable over time. It was not. The 15

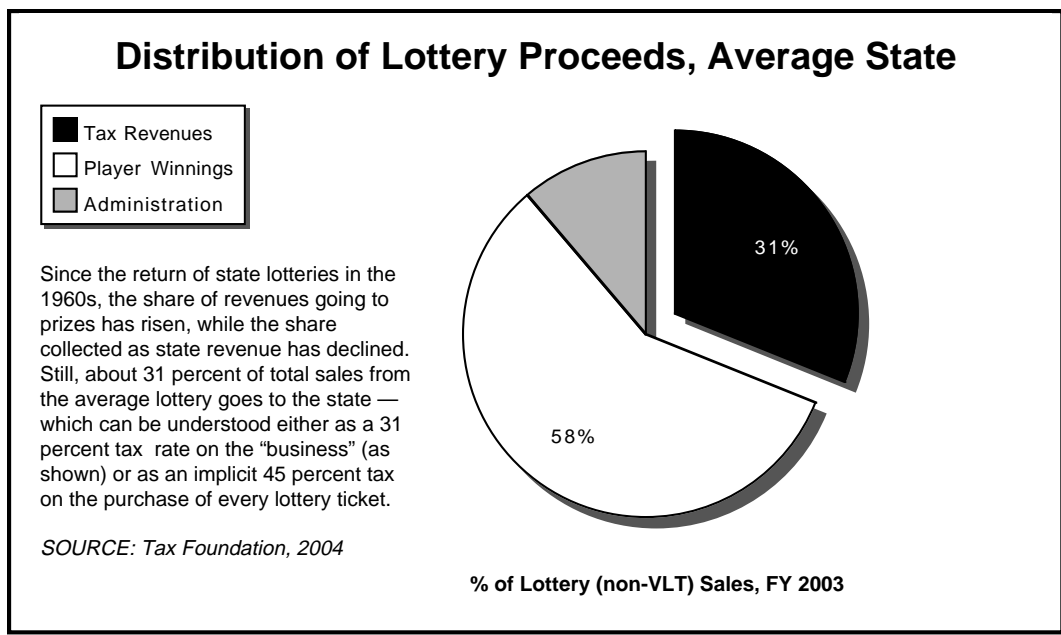
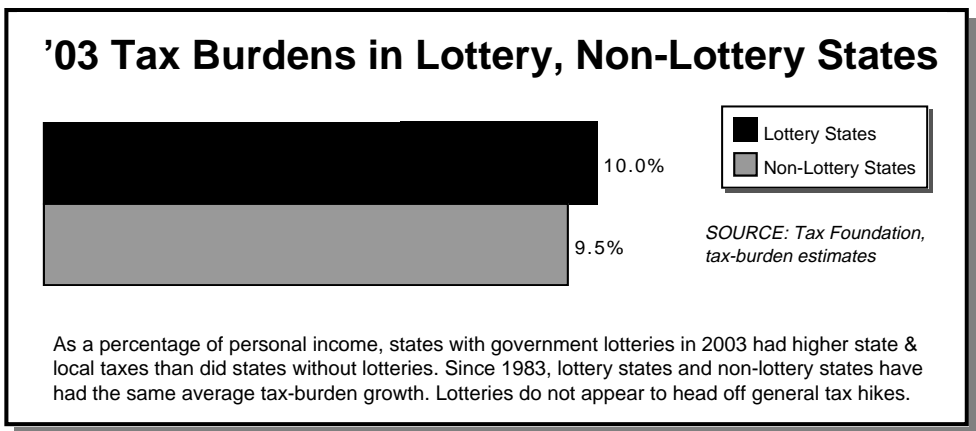
states that had fully operational lotteries at the beginning of the period (1983) saw their tax burdens rise and fall during the ensuing 20 years. So did the 12 states that remained lottery-free during the same years. At the end, both tax burdens were 0.2 percentage-points higher. Based on these data, it would be hard to conclude that lotteries act as substitutes for general taxes in the minds of politicians. They simply use both sources of revenue as complementary means of growing government.

### Lotteries as Taxes

There's a more fundamental problem with the notion that creating a state lottery would be a way to avoid raising taxes. A lottery is a government gambling monopoly, largely shielded from competition and used as a means of making gamblers pay a disproportionate share of the cost of government. In other words, it is itself a form of taxation. There are two different ways of conceptualizing how the lottery tax operates. The first is that the lottery enterprise is a business or industry subject to a gross receipts tax. Since in FY 2003 the average state lottery transferred about 31 percent of proceeds to government coffers, that is essentially the tax rate on the lottery enterprise.

The other way to think about the lottery tax is as a sales or excise tax on the money players spend buying lottery tickets. If the share of lottery receipts used as prizes (58 percent) and the remaining administrative expenses (11 percent) are added together as the actual price of each ticket, then the lottery tax — the additional money players must pay government for permission to play — has an implicit rate of about 45 percent (31 percent divided by 69 percent).

The choice of which taxation model to apply here isn't the critical issue. Essentially, that debate is about the degree to which the incidence of the lottery tax falls on several groups: on ticket purchasers, on winners, and on retailers, vendors, and others involved in administering the game. Whether the tax rate is 31 percent or 45 percent, it is clearly higher than the effective state tax rate on virtually any other expenditure. Thus, as North Carolinians shift their spending from other consumer goods to lottery tickets, the share of that spending going to government will rise. That's a tax increase by any reasonable definition.



Furthermore, it makes little sense to attempt to distinguish the lottery from a tax because it is a "voluntary" source of revenue. The same could be said of state taxes on alcohol, cigarettes, automobiles, gasoline, and a variety of other consumer purchases. Whether these are good or bad ideas is beside the point — no one seriously disputes that they are, indeed, taxes.

A state lottery in North Carolina is not an alternative to more taxes. It imposes more taxes.

-John Hood, President