CALIFORNIA BUDGET PROJECT

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BORROWING AGAINST THE FUTURE: ARE LOTTERY BONDS THE BEST WAY TO CLOSE THE BUDGET GAP?

As part of the May Revision to his 2008-09 Proposed Budget, the Governor proposes to sell $15 billion of bonds that would be repaid with future lottery revenues; $5.1 billion of this amount would be used to help balance the 2008-09 budget, and the remainder would be deposited in a new reserve. The Assembly's budget also assumes the sale of $15 billion of bonds backed by lottery proceeds. The Assembly would use $3.6 billion to pay 2008-09 General Fund obligations and the remainder to pay and prepay outstanding debt. Both proposals assume that lottery revenues can be substantially increased over a relatively short period. This *Budget Brief* examines the assumptions regarding increased lottery sales, whether the California lottery is underperforming, and policy issues raised by lottery bond proposals.

Where Did the Lottery Come From and What Does It Support?

Proposition 37, the California State Lottery Act, passed by voters in 1984, established the California lottery. The Act requires that lottery proceeds be divided between prizes (50 percent), administration (no more than 16 percent), and public schools (at least 34 percent).

Lottery funds are allocated annually on a per student basis to school and community college districts, the California State University (CSU), the University of California (UC), and other educational institutions. Most lottery funds allocated to education go to K-12 and community college districts. In 2006-07, elementary and secondary schools received eight out of 10 lottery fund dollars (80.6 percent) and community colleges received nearly one out of seven lottery fund dollars (13.7 percent).[1]

The Governor's Proposal Does Not Add Up

Details of the Governor's proposal are not publicly available. However, the May Revision states the Governor's intention to place a measure that would modify the California State Lottery Act on the November 2008 ballot. The Governor claims that these changes would increase lottery sales. The Governor would also provide schools a flat dollar amount of $1.2 billion, rather than the current fixed percentage of lottery proceeds. If voters approve changes to the Lottery Act, the Governor proposes to sell $15 billion in bonds that would be repaid with future lottery proceeds. Of the bond proceeds, $5.1 billion would be used to fill the 2008-09 budget gap and the remainder would go to a reserve linked to a new spending cap. A temporary one cent sales tax increase would be triggered if the lottery bond sale is blocked or the reserve is not adequately funded.

The Governor's Department of Finance hired a private consultant to analyze the lottery bond proposal based on a series of assumptions, including a target of $15 billion in bond proceeds and providing $1.2 billion from lottery revenues to education each year.[2] The consultant analyzed two scenarios. The first, assumed that annual per capita lottery sales would more than double, rising from $88 to $189, over a period of five years. The second scenario assumed the same increase in per capita lottery sales over a period of 10 years.[3] Even using the Governor's extremely optimistic assumption of more than doubling per capita lottery sales over five years:

- Lottery proceeds would be insufficient to meet payments to schools, debt service, prizes, and administrative costs until 2013.
- The obligations that would be paid from lottery proceeds would exceed projected lottery sales by $2.4 billion between 2009 and 2012.
- Total debt service costs for repayment the lottery bonds, including principal and interest, would be $41.5 billion.

Under the Governor's assumption that lottery sales would increase to $189 per capita within 10 years:

- Lottery proceeds would be insufficient to meet payments to schools, debt service, prizes, and administrative costs until 2018.
- The obligations that would be paid from lottery proceeds would exceed the Governor's projected lottery revenues by $11.4 billion between 2009 and 2017.
- Total debt service payments for repayment of the lottery bonds, including principal and interest, would be $52.5 billion.

The Assembly's Lottery Proposal May Create Future Budgetary Pressures

The Assembly's 2008-09 Budget Committee report included a lottery bond proposal similar to that of the Governor.[4] Instead of providing education $1.2 billion per year, however, the Assembly's proposal would add $1.2 billion to the Proposition 98 base in 2009-10, boosting ongoing funding for K-14 education. The additional amount would increase each year by the same percentage as the Proposition 98 guarantee.[5] K-14 education would likely receive more funding under the Assembly's proposal than it would under the Governor's plan. To the extent that the Assembly's proposal would increase funding for K-14 education, this increase could reduce funds available to support other programs, such as health care and human services as well as the remainder of higher education, including student aid, the UC, and the CSU.

The Assembly's lottery proposal differs from the Governor's in one other respect. The Assembly's proposal uses $3.6 billion of the $15 billion in proceeds from the sale of lottery bonds to pay 2008-09 General Fund obligations and $1.5 billion to prepay outstanding debt; the remainder would be used to prepay and pay debt in future years that would otherwise be paid out of the General Fund.

Is the Lottery Underperforming?

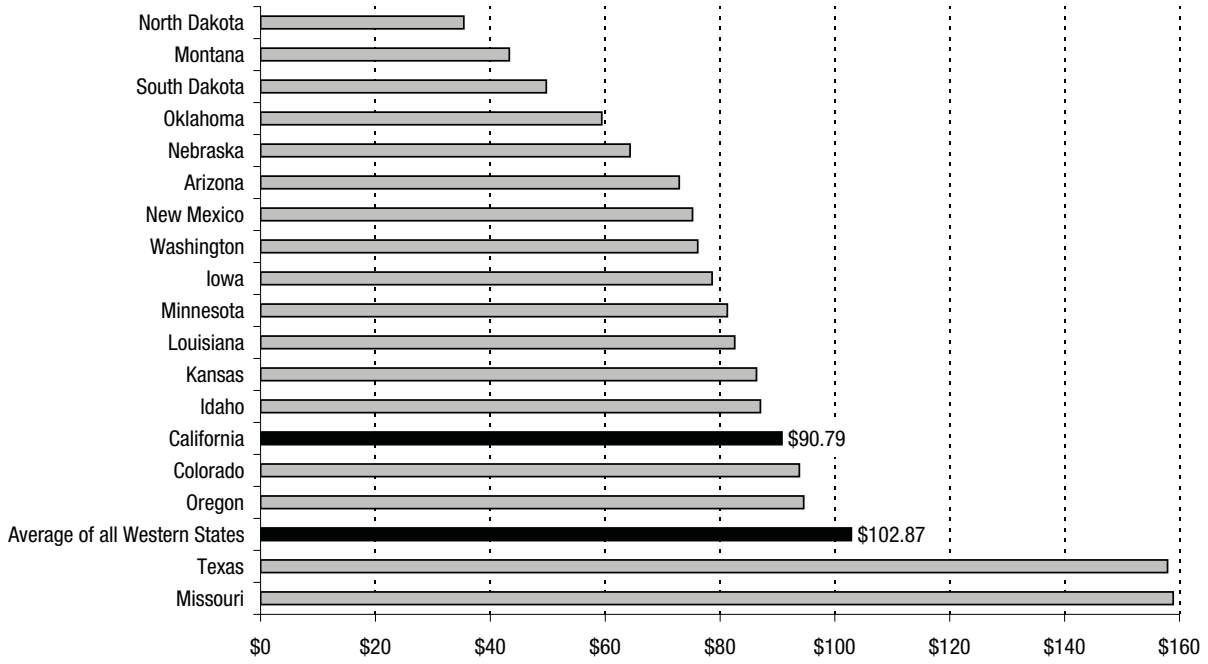
The Governor claims that, compared to other states, "California's lottery is an underperformer."[6] The Governor's May Revision to his 2008-09 Proposed Budget indicates that California's per capita lottery sales are less than half of the national average and compare even less favorably when measured against the 10 most populous states.[7] However, California's 2006-07 per capita lottery sales were greater than those of 13 of the 18 states with lotteries that are west of the Mississippi River, all of which have per capita sales below the national average (Figure 1).[8] Furthermore, California's lottery revenue increased from $2.1 billion in 1996-97 to an estimated $3.1 billion in 2007-08 (Figure 2).[9] While it may be possible to increase lottery sales, the Legislative Analyst's Office recently characterized the Governor's assumptions about the ability of the lottery to increase its sales as "overly optimistic and potentially unobtainable."[10]

Gaming Revenues Are Falling

California lottery revenues decreased by 7.4 percent between 2005-06 and 2006-07.[11] Despite adding 1,000 new lottery retailers this year, the California State Lottery Commission recently revised sales goals for 2007-08 to reflect a projected 7.9 percent decrease in lottery revenues from 2006-07. Lottery revenues are falling in many other states as well: between 2006 and 2007, per capita lottery sales decreased in 24 of the 43 states with lotteries and average per capita lottery sales in states with lotteries west of the Mississippi River decreased by 3.9 percent.[12]

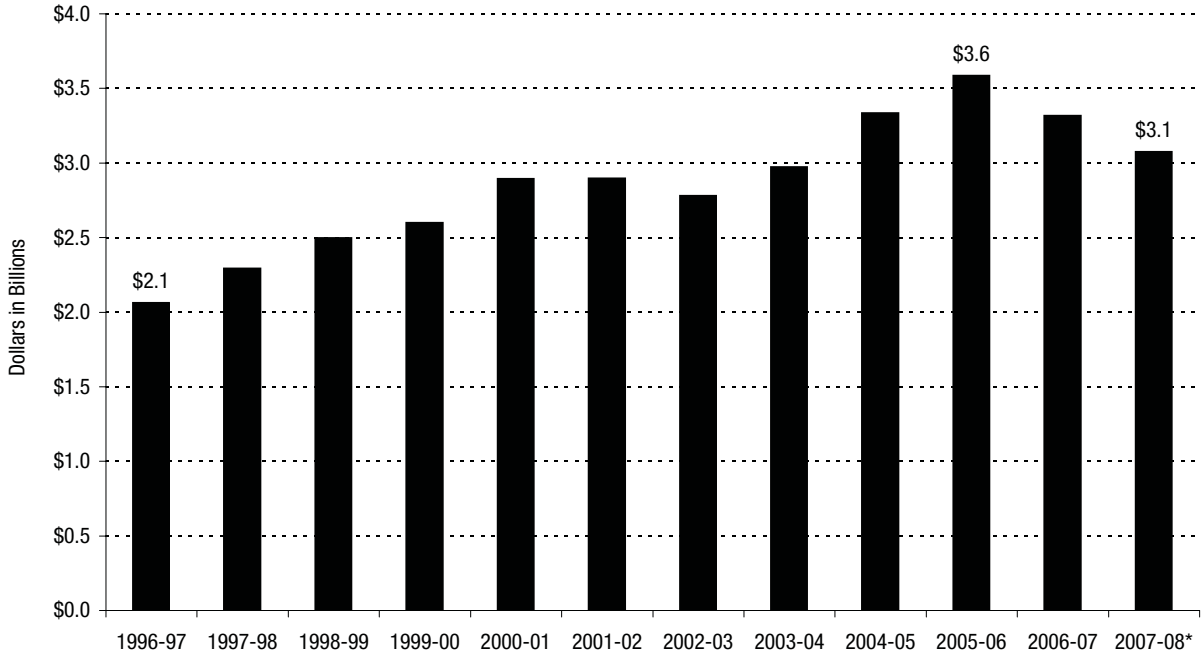
Recent declines in lottery revenues mirror other gaming revenue trends. For example, the amount of money wagered on horse racing in the US declined by 3.0 percent from $15.2 billion per year in 2003 to $14.7 billion in 2007. While tribal gaming revenues in California continue to increase year to year, the annual growth rate has declined steadily from 27.5 percent in 2003 to 9.8 percent in 2006.[13] Gaming revenues in Nevada have declined thus far in 2007-08 and two out of four big casinos in Lake Tahoe filed for bankruptcy protection in May. Recently, the California State Lottery Commission cited the poor economy and rising gas prices as potential reasons for declining lottery sales. However, saturation of the gaming market also may be a reason for decreases in lottery revenues.

Figure 1: Lottery Sales Per Person for States West of the Mississippi, 2006-07



Note: Excludes video lottery terminal sales.
Source: *La Fleur's 2008 World Lottery Almanac*

Figure 2: California Lottery Revenues, 1996-97 to 2007-08



* 2007-08 estimated.
Source: California Lottery

Maximizing Lottery Revenues: Who Will Buy the Tickets?

The Governor's lottery proposal assumes a substantial increase in lottery sales. Research suggests that proposals to boost lottery sales are likely to disproportionately impact lower income and non-white Californians. One national study found that individuals with lower incomes spend more on lottery tickets per capita than those with higher incomes.[14] Other studies conclude that lottery sales are higher for individuals who have little or no formal education, are residents of urban areas, are between the ages of 45 and 65, and are not white.[15]

The most recent annual financial report released by the California State Lottery Commission indicates that nearly four out of 10 lottery players (39 percent) come from households that earn less than $35,000 per year.[16] A recent study of California's lottery players by the Anderson School of Management and Department of Statistics at the University of California, Los Angeles found per capita lottery spending increases sharply as income falls.[17] The study also found that non-white lottery players spend more than whites.[18] By definition, increasing lottery revenues requires boosting the amount Californians spend on lottery tickets. While some argue that individuals can choose whether or not to buy lottery tickets, others argue that it would be inappropriate for the state to balance its budget by transferring a larger share of the cost of public services to those who are least able to afford to pay. Under the Governor's proposal, per capita lottery sales would increase by $101, from $88 to $189 per year. In contrast, the typical California vehicle owner saved $124 per vehicle when the Governor cut the Vehicle License Fee rate after his election in 2003.

Increased Lottery Sales May Mean Lower Sales Tax Revenues

Modifying the lottery could lead to additional lottery sales, but increased lottery sales would likely lead to a reduction in state sales tax revenues and other revenues attributable to consumer purchases, such as fuel, tobacco, and alcoholic beverage taxes. Research suggests that the money Californians spend on lottery tickets may result in a reduction in spending on other goods, including goods subject to the state's sales tax.[19] To the extent lottery ticket buyers spend less on taxable goods, the lottery would reduce state sales tax revenues and thus the funds available for public education and other services.

Policy Considerations

Proposals to issue bonds based on future lottery proceeds raise a number of important policy questions:

- **How would the Governor's lottery proposal affect public school funding?** The Governor's proposal assumes education would receive $1.2 billion annually. However, even if lottery sales reach the Governor's optimistic assumptions, lottery proceeds would not be sufficient to cover the cost of the state's obligations to schools, debt service, prizes, and administrative costs until at least 2013. Under the Governor's proposal, investors would be the first to be paid from lottery proceeds and, contrary to current law, education would not be guaranteed a percentage of lottery revenues. Under the Governor's proposal, education would receive no more than $1.2 billion per year. In contrast, under the current allocation formula, schools would receive $2.3 billion in 2012-13, the first year lottery sales would provide sufficient funds to meet all of the obligations specified in the Governor's proposal.[20]

- **Who is at risk if lottery revenues do not meet projections?** The Governor's lottery proposal assumes lottery bond investors would receive "first call" on lottery proceeds. It appears that the Governor plans to issue bonds structured so that investors would not have recourse to the state's General Fund. However, investors would likely require a greater rate of return on this type of investment, which would increase the costs of borrowing. Furthermore, should the state fall short on payments to investors, this could raise the cost of other state borrowing. If lottery revenues are insufficient to meet obligations for prize payouts, administrative costs, and schools – as the Governor's own assumptions indicate they would be for several years – the state's General Fund would be at risk.

- **How would changes to the lottery affect low-income Californians?** Since low-income Californians disproportionately purchase lottery tickets, any attempt to boost lottery sales to generate revenues for the state would implicitly increase the amount low-income Californians pay for the cost of public services. Low-income Californians already spend a larger share of their incomes on state and local taxes than do higher-income households.[21] At a time of record home foreclosures and a weakening economy, lawmakers should carefully consider whether it is appropriate public policy to ask those who already pay the largest share of their incomes for public services, and who struggle to make ends meet, to pay more in order to help balance the state's budget.

- **What might securitizing lottery proceeds mean for California's credit rating?** Officials from the State Treasurer's and Controller's offices have suggested that financial markets may view securitization of lottery proceeds as risky. The risk stems from the need for voters to approve changes to the share of lottery proceeds devoted to education, the potential for litigation over conflicts with existing tribal gaming compacts, and the risk that lottery revenues will not increase at the rate assumed by the Governor's or Assembly's proposal. These factors have several potential implications for the budget. First, to the extent investors believe that lottery proceeds may not be sufficient to cover the cost of prizes, administration, debt service, and other obligations, they will demand a higher rate of return as compensation for the increased risk. This, in turn, would increase the state's cost of borrowing. Second, if financial markets view the need for voters to approve changes to the lottery's operations and the potential for litigation as risky – thus endangering the state's receipt of lottery bond proceeds – the state's costs for other borrowing, such as routine cash flow and General Obligation bond borrowing, could increase. This latter factor is particularly significant this year in light of the turmoil in financial markets more generally.

Conclusion

The Governor claims that private investors may pay billions of dollars for bonds backed by lottery proceeds. Central to the Governor's lottery proposal is the assumption that lottery revenues will more than double in the next five to 10 years. In order to increase sales, the state would likely encourage low-income Californians to spend more of their limited dollars on the lottery. Furthermore, increased lottery sales would likely reduce state sales and/or other consumption-based tax revenues. While the Governor claims that his proposal would maintain education funding at present levels, lottery bond holders would be the first to be paid from lottery revenues and education would not be guaranteed a share of lottery proceeds as they are under current law. Furthermore, potential increases in lottery revenues would not result in increases in education funding as they do currently. Under the Assembly's lottery proposal, base funding for K-14 education would increase; however, if lottery sales fall, funds available for other programs, such as health care and human services, could be reduced.

Jonathan Kaplan prepared this Budget Brief with assistance from Jean Ross. The California Budget Project (CBP) was founded in 1994 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low- and middle-income Californians. General operating support for the CBP is provided by foundation grants, individual donations, and subscriptions. Please visit the CBP's website at www.cbp.org.

ENDNOTES

[1] Department of Finance, *Governor's Budget 2008-09*, p. LJE 171, downloaded from http://www.ebudget.ca.gov/pdf/GovernorsBudget/0010.pdf on June 5, 2008.

[2] Lamont Financial Services letter to Fred Klass, Department of Finance (no date).

[3] According to Lamont Financial Services Corporation, per capita lottery sales were "projected to be realized on a straight line basis over either 5 or 10 years until they reached $189 per capita (2006 U.S. national average), after which, no further growth is assumed."

[4] Assembly Budget Committee, *2008-09 Subcommittee Report* (June 5, 2008), p. 4. The Senate rejected the Governor's lottery bond proposal.

[5] In all but Test 1 years, the additional funding would increase by the percent change in enrollment and an inflation factor. See California Budget Project, *School Finance in California and the Proposition 98 Guarantee* (April 2006).

[6] Department of Finance, *Governor's Budget May Revision 2008-09*, p. 3.

[7] Department of Finance, *Governor's Budget May Revision 2008-09*, p. 3.

[8] Teresa E. La Fleur and Bruce A. La Fleur, eds., *La Fleur's 2008 World Lottery Almanac*, 16th ed. (April 7, 2008), p. 19.

[9] California Lottery, *Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2007* (December 31, 2007), pp. 46-47. While lottery revenues have increased over the past 12 years, lottery funds have declined as a share of overall K-12 spending since the lottery's inception. See California Budget Project, *The California Lottery: A Small and Declining Share of School Funding* (March 2007).

[10] Legislative Analyst's Office, *Overview of the 2008-09 May Revision* (May 19, 2008), p. 23.

[11] California Lottery, *Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2007* (December 31, 2007), pp. 46-47.

[12] CBP analysis of *La Fleur's 2008 World Lottery Almanac* data.

[13] Alan Meister, Ph.D., *Casino City's Indian Gaming Industry Report*, 2007-2008 ed. (Newton: Casino City Press, 2007), p. 20.

[14] Charles T. Clotfelter, et al., *State Lotteries at the Turn of the Century: Report to the National Gambling Impact Study Commission* (June 1, 1999), p. 13.

[15] Thomas A. Garrett and Russell S. Sobel, *State Lottery Revenue: The Importance of Game Characteristics* (Federal Reserve Bank of St. Louis: 2002), pp. 1-2.

[16] California Lottery, *Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2007* (December 31, 2007), p. 53.

[17] Edward Leamer and Don Ylvisaker, *Player Demographics and Payout Strategies* (Anderson School of Management and Department of Statistics UCLA: November 5, 2007), p.12. The study states that "per capita lottery spending goes up sharply as income falls, to a point, then changes little as income goes lower."

[18] Edward Leamer and Don Ylvisaker, *Player Demographics and Payout Strategies* (Anderson School of Management and Department of Statistics UCLA: November 5, 2007), p.19.

[19] Charlene Wear Simmons, Ph.D., *Gambling in the Golden State: 1998 Forward* (California Research Bureau: May 2006), p. 92.

[20] Assumes lottery sales increase by an equal dollar amount each year until the national average is reached.

[21] See California Budget Project, *Who Pays Taxes in California?* (April 2008).