Is An Education Lottery Right for Oklahoma?

by Timothy D. Terrell

Any debate on a state education lottery may appear to reduce to a contest between those concerned with morality questions and gambling addiction on one hand, and promoters of education on the other. Yet this may oversimplify the discussion. Without downplaying the importance of moral issues or the social consequences of habitual gambling, we should recognize that a state lottery may produce significant negative economic effects. A brief review of some of the evidence suggests that state education lotteries may harm some businesses while failing to produce the advertised benefits for education. A lottery sets the state government up as a competitor to private businesses, and encourages a misallocation of valuable resources. At the same time, projections of lottery profits are unrealistic, if the results obtained by lotteries in neighboring states are any guide. Lottery proponents have indicated that $300 million in net profits can be anticipated, while a figure 60 percent smaller would be more reasonable. Studies have shown, too, that much of this money would be raised from low-income households. Certainly, before Oklahoma decides on a lottery, voters should become aware of these concerns.

A State Lottery vs. the Private Sector

In a very real sense, state lotteries pit state governments against certain businesses and private citizens. First, in order for the state to make consistent profits, any significant competition has to be suppressed. That means no lotteries of any size can be allowed in the private sector.

tate lotteries routinely clear profits of 20 to 35 percent. Any private business consistently making profits that large is either facing immense risk that warrants the high return, or has the government on its side suppressing the competition (as with a patent). Otherwise, that business is about to see those profits diminish sharply as other firms begin to jump in to the market. In the lottery business, a firm offering 45 percent payouts (with 15 percent in other costs and 40 percent profit) would bedriven out of the market by a competitor offering 50 percent payouts (and taking only 35 percent in profit). Ultimately, free competition in the lottery industry would mean efficiency in administrative costs, bigger payouts, and profits not significantly greater than in other businesses requiring similar talents and risk-taking. Competing legal lotteries would still provide revenue to the state through existing taxes, but state governments generally prefer the substantial profits of a monopoly. To the extent that they limit the competitive process, state lotteries damage the American system of free enterprise.

Some have pointed out that any lottery legislation in Oklahoma would legalize Indian lotteries as well. Indian tribes might be able to offer larger prizes and compete to some extent with a state lottery. Yet the Indian lotteries would not be allowed to sell tickets statewide, a major competitive disadvantage. Likewise, access to Internet lotteries in other states does not pose a serious threat to profits as long as most tickets are sold over-the-counter. Because of the income levels of many ticket buyers, and the small dollar amounts of most individual ticket purchases, much of the revenue is going to be obtained offline and in cash.

While it may be difficult to envision a group of would-be competitors who are harmed by the state lottery because they were barred from starting similar businesses, there are those with currently

functioning businesses who would also be harmed. Beyond the lottery itself, a state lottery competes in a broader sense with other forms of entertainment run by private businesses. Other types of organized betting would suffer as people buy lottery tickets instead of patronizing a private firm that provides those services. Certainly the horse racing groups that helped to oppose the state lottery in 1994 recognized the damage it would do to their business.

Even more broadly, lottery tickets will compete with other goods and services (not necessarily entertainment) that people usually purchase. This would be seen at any convenience store, where lottery ticket sales crowd out other sales at that store. Yet, as people implicitly factor lottery ticket purchases into their overall spending pattern, they might buy a little less at department stores, spend a little less at restaurants, and rent fewer movies. Or they might save a little less, leaving them less well-prepared for financial bumps in the road. In every case, someone is hurt—the retail salesman who missed a sale, the server in a restaurant who sees lower tips, or the family paying fees at a check advance firm because the savings account went dry. It may be virtually imperceptible in individual cases, but the money for lottery tickets is coming from somewhere. Oklahomans have to decide: Do we really want to enable the government to compete with businesses in this state?

Of course, not everyone would be made worse off by a state lottery. After all, a lottery not only takes money in, but it spends it as well. One possible winner is the advertising industry. Advertising for the lottery would be substantial, amounting into the tens of millions of dollars. While this benefits advertising firms, however, the spending for lottery ads will crowd out other customers. A state lottery sets the government up to compete with private firms who also want billboard space, TV and radio time, and newspaper ads. Ad rates can be expected to rise with the increased demand from lottery ads, and private businesses will pay the bill. Ultimately, those individuals and businesses close to the government and its schools are in a position to gain something, however small, from a lottery. Those who are more distant will lose.

One could argue that perhaps the gains to ad firms and other "winners" would outweigh the lossesto competing entertainment firms and other "losers." Yet this would be a doubtful claim, and impossible to prove. Shifting resources about with a monopolistic state lottery distorts the economy in such a way as to almost certainly produce a net loss, as the allocation of resources is modified from what it would otherwise be in a free, competitive system.

With the funds being directed toward education, one favored group is clear. Public schools — and their administrators, teachers, students, and suppliers — would gain something. Yet even the disbursement of lottery revenues could potentially harm certain groups in the state. Public schools and colleges are necessarily in competition with private institutions. Funding public school programs, or granting raises to administrators and instructors in public institutions means that the private sector is placed at a competitive disadvantage. Raising tuition to pay for raises to match the public schools only widens the gap between the private schools and the free public schools, and drives students away.

Given this last difficulty, perhaps any funds raised by a lottery should be devoted to tax credits for parents with children in public, private, or home schools. Parents who send their children to public schools would lose the tax credit, but instead of counterbalancing the lost tax revenues the funds would be transferred directly to the school district where their children attend. The benefit is current and highly visible (which should satisfy politicians), allows local control, is targeted toward education, and has no bias against families who home-school or send their children to private schools. There are about 931,000 Oklahomans ages 3 and over who are in some sort of school. If the lottery manages to raise the

$300 million that its advocates expect (but see discussion below), the tax credit would amount to a little over $300 per student.

Toward Realistic Projections of Lottery Benefits

Texas, Missouri, Kansas, Colorado, and New Mexico have lotteries. Yet while lottery proponents are quite eager to bring up the fact that neighboring states have a few Oklahoma customers, they are not willing to use the neighboring states to estimate likely revenues from the lottery. As David Averill of the Tulsa World pointed out recently, this yields a wildly inflated projection of lottery profits. Lottery advocates have been advertising expected profits of $300 million a year. The most successful lottery among neighboring states is in Texas, where sales amount to $127.45 per person per year, and profits total 33 percent of sales. The least successful lottery is in New Mexico, where lottery sales average $60.77 per person and profits are only 22 percent of sales.

If a lottery in Oklahoma matched Texas' performance, Oklahoma's state government would net about $145 million. If it came up only to New Mexico's performance, the state government would bring in only $46 million. Yet lottery advocates go to Oregon for their estimates, claiming that Oregon is similar to Oklahoma because of smaller populations and an "economic giant" next door (Texas for Oklahomans, California for Oregonians). What the presence of Texas next door has to do with lottery ticket sales is unfathomable. As Averill noted, there are actually important differences between Oregon and Oklahoma — particularly income. Oregon's per capita income is 13 percent higher than Oklahoma's, meaning that Oregon residents have more to spend on lottery tickets than Oklahomans.

Oklahoma's five neighbors had average annual sales per capita of $87 in FY 2001. Assuming that Governor Henry's goal of 40 percent of lottery revenues going to a trust fund is achieved, attaining the same level of sales in Oklahoma would produce only about $120 million for that fund per year. This is about five percent of the 2002-2003 expenditures for education of $2.3 billion, hardly a windfall.

Even if the lottery manages to raise the $300 million projected by lottery proponents, this would not necessarily result in state schools receiving an additional $300 million. With the pressure off legislators to "do something" for education, they respond to other groups who are clamoring for funding. Public education gets less in future budgets, so that the lottery revenues replace, rather than supplement, normal education spending. A 1995 study that examined lotteries in seven states found that, in four of those states, education spending actually dropped after a lottery was introduced.1

Lottery advocates in Oklahoma have said that this problem could be solved by passing a law fixing the portion of the state's budget going to education, as California did. However, resorting to constraints on future budgets cannot truly solve the problem. First, these limits can always be liftedby a future legislature, so there is no guarantee that the current educational priorities will be maintained in the future budgets. Second, fixing a budget amount for education or any other purpose necessarily ignores the changes in relative needs from year to year. For example, as demographics change, the amount of money going to education will need to change accordingly. An aging population might insist upon more subsidies to medical care; a smaller percentage of the population in the kindergarten-college age group would mean that funding could be diverted from education to where it is in greater demand. Attempts to bind future legislatures could produce a misallocation of budget resources in the future.

Lottery advocates have indicated that funds raised through a lottery would be placed into a trust fund to be governed by elected officials. This would eliminate fluctuations in funding that would come from notoriously inconsistent lottery revenues. However, it should be pointed out that other trust funds that

are managed by politicians, like Social Security, are routinely raided for other purposes. Politicians, faced as they are with a short time horizon (the next election), have strong incentives to produce perceptible current benefits for their constituencies, even if it means large, though obscure, future costs.

Political Aspects of a Lottery Decision

Historically, politicians have had difficulty with any policy that appears to place a disproportionate burden on the poor. This makes the popularity of state lotteries that much more surprising, because lotteries are clearly regressive. Lottery studies have difficulty finding anything but a negative relationship between income and the percentage of one's income spent on lotteries. The Public Sector Gaming Study Commission (PSGSC) argued that lotteries are not more attractive to the poor than those with higher incomes. Using data from a well-known 1998 national study on gambling behavior for the National Gambling Impact Study Commission, the PSGSC found that individuals in the lowest income category (with total family income of less than $24,000 per year) spent an average of $5.00 the last time they purchased lottery tickets. Those with annual incomes between $50,000 and $100,000 spent an average of $7, which is 40 percent more than the lowest income group. Those earning above $100,000 spent $6.70, which is also significantly above the lottery spending of the bottom income group.2

The PSGSC found that there is no relationship between income and the frequency of ticket purchases. Yet the data this group provides reveals that, while the poor may not spend as much as the wealthy do in absolute terms, the poor certainly spend more as a percentage of their income.

Someone with a total household income of $24,000 who buys lottery tickets once every three weeks, spending an average of $5 each time, spends about $87 a year. Someone with a total household income of $100,000 who buys lottery tickets just as frequently, and spends an average of $7 each time, is spending about $121 a year. The poorer individual is spending three times the proportion of his income on the lottery than the wealthier individual. If anything, this ratio probably under-represents the regressivity of the lottery. A study of lottery spending in Atlanta indicated that lottery spending by low-income households was, as a percentage of total income, five times as much as middle or upper-income households.3 Any income tax that required the poor to pay 50 percent of their income while requiring the wealthy to pay 10 percent would attract widespread criticism.

Other studies reveal that it is indeed the poor who are funding state lotteries. Data collected in 1997 on lottery ticket purchases in Lexington, Kentucky found that 79 percent of the revenues came from ZIP codes where the per capita income was below the county average.4 In Maryland, 47 percent of the most frequent lottery players are in households with incomes of less than $20,000 a year.5

How a lottery decision would be made is a question in itself. The problem with a referendum on the lottery (as Mr. Henry wants) would be that the lottery may be mildly favored by a majority, but strongly opposed by a minority. A lottery might provide slight benefits to a large number of people, but much larger costs to a minority. Thus, a lottery that actually causes net harm would pass in a referendum. Perhaps in this case, going through the legislature would be a superior way of deciding the issue.

In sum, the lottery decision in Oklahoma should be approached carefully, with due consideration of all potential consequences. If certain business owners or private educators stand to lose from a state lottery, their concerns should be respected. If lottery revenue projections have been overstated, or if the state cannot truly guarantee that those revenues will not replace current funding, then the public should

be given a more realistic appraisal of the benefits. If the lottery would be funded by the poor, this should be made clear as well. Before Oklahomans decide on a lottery for education, they need more education about the lottery.

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Originally published in the January, 2003 issue of Perspective.

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