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THE POLITICAL ECONOMY OF CASINO LICENSING: A CASE STUDY ON MARYLAND'S EXPERIENCE

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Abstract
This paper will argue that casino licensing—the primary method of regulation that states employ to legalize casinos—creates an environment conducive to cronyism and regulatory capture. Well-connected firms lobby for the monopoly right to conduct their business in a state, inevitably linking casino corporations with the political process. While evidence of this phenomenon is observed nationwide, this paper will explore Maryland's experience with casino legalization. More specifically, it will examine how the licensing process and subsequent political favoritism produced the upcoming $925 million MGM Resorts Casino in National Harbor, Maryland.

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Introduction

Four decades ago, gamblers seeking to wager their money in legal casinos had no other choice than the state of Nevada. Today, with legalized casinos in 23 different states, people have a much wider range of choices. With the greater freedom and opportunity to get a share of this new market came red tape and the incentive to garner political favor. Most of these 23 states regulate casinos through licensing. As I will attempt to show, licensing casinos leads to cronyism, which for many reasons is undesirable.

Licensing and outright bans on casinos exist in practice because some people believe that if casinos were legalized, or left unregulated, they would produce negative externalities. However, economic analysis demonstrates that there is a gap here between the intentions and the results of regulation. In the case of bans, even though they are intended to reduce crime and minimize the social costs of casinos, they often result in the exact opposite: increases in crime, violence, and corruption. If a ban on casinos in a particular state is lifted, it is most likely that it will be replaced with regulations on the market for gambling. Traditionally, the regulatory avenue chosen is licensing. Casino licenses are granted to private companies by a state gaming regulatory commission, which also decides where casinos will be located and how they will be taxed. Because companies vying for casino licenses have an immense monetary incentive to seek favor with the public officials in charge of making the decisions, this arrangement becomes a breeding ground for cronyism. The principles of economics as well as public choice theory help to explain why this occurs and why it is troublesome.

In Section II, I will present traditional arguments against casino legalization and use economic theory to illustrate the high cost and low efficacy of prohibition. I will offer contemporary evidence of this phenomenon as it relates to casino prohibition. I will then shift to an economic analysis of what happens when casinos are legalized and regulated. Typically, once legalized, casinos are heavily regulated through licensing, justified on the basis of the public interest theory of regulation. I will present the flaws of the public interest theory of regulation, and offer support for the theory of regulatory capture instead. Arguments concerning regulatory capture are often advanced by economists of the public choice tradition. When the regulators become captured by special interests, the result is a corrupted form of capitalism called cronyism. The licensing process leads the interests of the government and casinos to become intertwined. Costly unintended consequences could be avoided if we set aside the licensing regime and force casinos to compete on the open market on the basis of price and quality.

Section III applies the theoretical framework to Maryland's experience with legalized casinos. Maryland makes a good case study because its approach to casino regulation led to clear instances of rent-seeking and regulatory capture. In 2008, Maryland's Video Lottery Facility Location Commission (VLFLC) was created and tasked with choosing where five new casinos would be located. For each geographic area selected, the VLFLC helped establish a local economic development council to advise the municipality on how to use the tax revenue generated by the casino. Maryland's sixth and most recent license was awarded to MGM Resorts to build a $925 million casino at National Harbor. The connections between the politicians and MGM Resorts casino interests are hidden in plain sight: they are not advertised, but they are not very difficult to uncover.

Section IV will summarize and conclude.

Theoretical Framework of the Political Economy of Casino Legalization

Traditional Arguments against Casino Legalization and Their Downfalls

Arguments against legalized gambling are generally advanced by religious groups who believe that casinos are inextricably linked to crime and that gamblers, once addicted, need to be saved from themselves. These standard arguments for banning or regulating casino gambling suffer from fundamental problems.

First of all, there is no real distinction between gambling and other entertainment commodities. People pay for video games, movies, and many other entertainment commodities that have no expected monetary payoff. Arguably, casinos serve the same function as video games, except they provide a chance for participants to win money. Indeed, gambling is no different than any other consumption good that consumers willingly pay money for—the consumers spend money on it because they derive utility from it. However, those who advocate for banning casinos often focus, not on the costs to the gamblers, but instead on societal costs.

The most frequently used arguments in favor of prohibition or heavy regulation of gambling rely on the assumption that compulsive gamblers impose enormous social costs upon society. In other words, they cause enormous negative externalities, a form of market failure.[1] However, many who cite social costs as a reason to ban gambling have either failed to define "social costs" or have defined them incorrectly, and in doing so have made social cost a subjective matter.

[1] Eadington, William, 1999.

In “The Social Costs of Gambling: An Economic Perspective,” Douglas Walker and A. H. Barnett discuss this issue at length. While they do not claim that the redistribution of wealth caused by gambling is irrelevant to policy decisions, they criticize those economists who adopt an ad hoc approach in identifying social costs of casino gaming and then attempt to quantify these costs. Social costs, Walker and Barnett explain, are defined as the amount by which an action reduces aggregate societal real wealth; private transfers are irrelevant.[2] But the lack of definition of what constitutes a social cost results in a conglomerate of whims and personal preferences that lead to personal policy recommendations not derived from economic science. Many academic scholars denounce casinos on the basis of social costs without ever delving into what the term “social cost” entails.[3]

For example, Robert Goodman, a leading voice against casinos, in his 1996 book *The Luck Business*, includes income lost by compulsive gamblers who become unemployed, money given by family members to compulsive gamblers, and money spent by the gamblers on gaming in his calculation of social costs. These are private transfers—not reductions in societal wealth, and therefore do not fit into the economic definition of a social cost. Furthermore, these arguments fall prey to the “zero-sum” fallacy of exchange. Gambled money does not just disappear, but rather the exchange is positive-sum: it is beneficial for both parties.

Earl Grinols and David B. Mustard have made similar claims against legalized gambling in several academic papers over the years, citing a staggering $40 billion in

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[2] Walker, Douglas M., and A.H. Barnett, 1999.
[3] See Goodman, R., 1994; Volberg, R., 1996; Grinols, E., and J. D. Omorov, 1996; K. Zorn 1998.

social externalities in their 2006 paper "Casinos, Crime, and Community Costs."[4] Their classification of social cost also does not align with the economic definition of social cost.

The benefits of casino legalization include increased consumer and producer surplus and increased government revenue for socially beneficial endeavors such as education and public works, but some say that addiction negates all these benefits. Those that make this argument fail to recognize that many commodities such as cigarettes, alcohol, and pornography are potentially addictive and yet legal. Engaging in addictive behaviors does not necessarily mean that someone is irrational; he or she may very well be rational. In 1988, Kevin Murphy and Nobel laureate economist Gary Becker developed the first model of addiction as a rational behavior.[5] While models of rational addiction are fairly technical and rely on a variety of assumptions, empirical tests confirm these models have substantial predictive power.[6]

Over the years, the Becker-Murphy model has faced criticism that it is inadequate to explain drug addiction. However, a recent study by Columbia University's Professor Carl Hart shows that even those addicted to crack cocaine or crystal methamphetamine behave rationally in how they respond to price changes. The participants in the studies were all addicts, mostly from low-income neighborhoods. They were blindfolded when given their daily dose of crack or meth, so that they were unaware of the amount. On days when the dose was small, overwhelmingly the addicts opted for the $5 in cash as opposed to another dose of drugs, but when the dose was larger, they chose to forgo the

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[4] Grinols, Earl L., and David B. Mustard, 2006.
[5] Becker, Gary, and Kevin Murphy, 1988.
[6] Walker and Barnett, 1999.

cash for more crack or meth. After the cash alternative increased to $20 for each round of drugs forgone, the addicts all chose the cash. When offered alternatives to drugs, the participants in the study made rational economic decisions based on the alternatives presented.[7] In view of studies such as these, combined with Becker's theoretical framework, it is easy to see why some economists doubt that addictive gambling is irrational.

Other negative effects often attributed to casino gaming, such as corruption, burglary, prostitution, and drugs, are similarly misplaced. Casinos are not as much of a cause for concern as those who call for bans would make it seem, because casinos do not cause crime. Many of the proposed linkages have not been researched in-depth, meaning the claims of a causal relationship are not well substantiated. Jeremy Margolis, former inspector general and former director of the Illinois State Police, in a comprehensive study on the empirics of casinos and crime "found little documentation of a causal relationship" between the presence of casinos and crime.[8] Essentially, he found that communities with casinos are just as safe as communities without them. As for the literature that claimed otherwise, Margolis observes that studies reporting increases in crime after casino openings fail to account for increases in the populations of surrounding areas.

Margolis further attributes the legalization of casinos to the dismantlement of organized crime. More generally, many of his findings belie the idea that casinos cause crime. For instance, Las Vegas has a lower crime rate than virtually every other major American tourist destination. Atlantic City's crime rate has fallen every year since 1991.

[7] Hart, Carl, 2013.
[8] Margolis, Jeremy, 1997.

He also found that crime in Baton Rouge, Louisiana, has decreased every year since gaming was introduced more than 20 years ago. Dr. Douglas Walker, in another comprehensive review of the literature, had similar findings.[9]

Most papers that find a link between casinos and crime make the error of omitting tourists from their measure of population. This discrepancy is important to note because crime is the key argument against casinos these days. The rise of legalized gambling in the United States has likely curtailed the opportunities for organized crime and its attendant violence.

While the opponents of legalized gambling cite costs of legalization, they virtually ignore two major costs of keeping gambling illegal: the costs of prohibition and the costs of regulation.

The Costs of Prohibition

Many opponents of legalizing gambling discuss the alleged social costs of gaming but neglect the significant costs of regulation and outright bans. One of the key insights from the economics of prohibition is that artificially reducing the supply of a good or service by making it illegal does not remove the demand for that good or service. Profit-seeking entrepreneurs willing to work outside of the law will enter the industry, and black markets will emerge. Further, the individuals who are willing to enter the market illegally will tend to have a high time preference, meaning they will be more willing to engage in risky behaviors. The case against prohibition—the 1930s prohibition on alcohol or any other government attempt to control consumption habits—is well laid out in Mark

[9] Walker, Douglas M., 2008.

Thornton's *Economics of Prohibition*.[10] Thornton identifies increases in crime, violence, and corruption as consequences of prohibition.

Since commercial casinos are illegal in Virginia, high-stakes poker games are played in private homes. In late January 2015, the Fairfax County SWAT team raided a high-stakes poker game consisting of 10 players in the basement of an estate in Great Falls, Virginia, where the police seized $150,000 in cash.[11] All participants were unarmed, but were charged with illegal gambling. Cases such as this one can be observed nationwide. Average citizens who normally would not be engaged in illegal activity find themselves drawn to criminal behavior under prohibition. Black markets increase crime by either drawing new people into the world of crime or making already practicing criminals engage in even higher numbers of criminal acts. Additionally, violence is more likely in black markets, because the traditional method of recourse in disputes (the court system) is unavailable to those operating in a black market.

These types of gambling raids are nothing new to the Commonwealth of Virginia, and as predicted by the economics of prohibition, violence is an inevitable consequence. In 2006, the Fairfax County SWAT team was called in to arrest a single suspect accused of betting on football games. During this raid, an officer accidentally shot and killed optometrist Salvatore J. Culosi Jr.[12] Following the incident, the police stated that in the future, raids would be conducted more judiciously. However, the tragic death has not stopped Virginia police from aggressively and violently enforcing gambling laws, as evidenced by the 2015 SWAT raid.

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[10] Thornton, Mark, 2014.
[11] Jackman, Tom, 2015.
[12] Jackman, Tom, 2015.

Prohibition often leads to corruption, because those who operate in the black market have an incentive to pay off government officials tasked with enforcing laws. There is widespread evidence of the linkage between illegal gambling and corruption. In a comprehensive study in the *Journal of Applied Economics*, Douglas Walker and Peter Calcagno find empirical evidence to supplement the mounting anecdotal evidence linking the casino industry with political corruption.[13] While their Granger-causality analysis offers substantial evidence for the link, anecdotal evidence is compelling as well. They offer an abundance of examples, including the arrest of four state senators in 2010 in Alabama on corruption charges related to gambling legislation. Another very recent example is that in November 2014, six Knox County, Tennessee, police officers were arrested for accepting bribes to move money in an illegal high-stakes poker game. Corruption is a predictable cost of government intervention, because the incentives of the enforcers of the law are altered under prohibition.[14]

The use of police to enforce the law that prohibits consenting adults from playing card games in a private home's basement is expensive and breeds crime, violence, and corruption. In fact, it even cost Dr. Culosi his life. Perhaps with the 2016 opening of the National Harbor Casino in Maryland, a mere 25-minute drive from Great Falls, Virginia, those with the desire to gamble will be able to do so in a legal environment without the fear of prosecution.

[13] Walker, Douglas M., and Peter Calcagno, 2013.
[14] Satterfield, Jamie, 2014.

The Costs of Regulation

If casinos become legalized in a given state, that minimizes the gambling-related black markets and their unintended consequences. However, rarely does the government just allow the market to operate; regulation is certain to follow. This is a direct result of the widespread belief in market failure. In the years before economists developed the theories of public choice and regulatory capture, scholars believed that regulations existed to correct market failures. And despite a massive body of contradicting evidence, today market failure remains a popular justification for intervention.

Arthur Pigou developed the public interest theory of regulation, which posits that agencies supply regulation in response to the demand of the public in order to fix inefficiencies or inequities in the market.[15] However, when economists in the public choice tradition began to test the hypothesis that regulations are prevalent in industries plagued with market failures, they discovered empirical evidence inconsistent with public interest theory, leading many to assert that public interest theory is flawed.[16] According to the public choice tradition, the notion that government officials are omniscient, benevolent actors who always serve the public interest is at odds with reality. In fact, consistently the opposite is true: regulators satisfy the private special interests of those who are well-connected politically at the expense of the larger public. This is not the fault of the regulators, and usually they are not by nature corrupt, but rather this phenomenon emerges because of the incentives inherent in political institutions.

[15] Pigou, Arthur Cecil, 1932.
[16] Thierer, 2012.

This empirical reality led to the development of regulatory capture theory by George Stigler in "The Theory of Economic Regulation.[17]" Capture theory argues that an agency designed to regulate an industry tends to be "captured" by that industry. In other words, either an agency issues a regulation to benefit an industry or the industry eventually comes to control the regulatory body over time, thereby issuing regulations that help the regulated. Regulatory capture is not a conspiracy theory. The phenomenon may arise simply because the regulator has an interest in the regulated doing well in order to raise revenue. Regulation also invites private interests to rent-seek in hopes of obtaining some sort of privilege. The result is cronyism, an economic system in which the profitability of businesses depends on political connections.

Cronyism is an undesirable by-product of government favoritism. Cronyism manifests itself in many ways, including monopoly privileges, regulatory privileges, tax privileges, subsidies, tariffs, and quotas.[18] There are many costs to cronyism, which include but are not limited to deadweight loss due to monopoly privilege, productive inefficiencies, unproductive entrepreneurship (rent-seeking), inattention to consumer desires, loss of innovation, and diminished long-term economic growth.[19] Furthermore, in an economy where cronyism is prevalent, the private sector, the government, and, more broadly, capitalism, are undermined.

Additionally, cronyism is inextricably linked with the size of government, as measured both by regulatory capacity and expenditures.[20] The larger the government, the

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[17] Stigler, George, 1971.
[18] For a comprehensive introduction to cronyism see *Liberalism and Cronyism: Two Rival Political and Economic Systems* by Randall Holcombe and Andrea Castillo (2013).
[19] Mitchell, Matthew, 2012.
[20] Holcombe, Randall, 2012.

more fertile the breeding ground for cronyism. The information and incentive structure of the government results in even the best-intentioned regulations benefitting cronies. Those in the system have an incentive to maintain the status quo. Government-bestowed privileges misdirect resources, impede economic progress, encourage corruption, and undermine government legitimacy.[21]

In Mancur Olson's famous work, *The Logic of Collective Action*, he explains that it is hard to prevent cronyism because those who bear the dispersed costs have far less of an incentive to organize than those who receive the concentrated benefits of the privileges. While there are targeted reforms that ought to be considered, the problem of cronyism is so widespread and complex with so many conflicting interests at play that it is unlikely to be solved anytime soon.

Most state constitutions explicitly ban casinos, so states must amend their constitutions if they choose to lift the prohibition. Gambling is unique in this way; it takes an act of government to legalize it, which inherently requires an examination of the costs and benefits of such a policy. The rationale behind gaming prohibition and regulation is to eliminate or at least minimize the social costs that come with casinos, which is also often linked to the moral argument that gambling is a self-destructive behavior and should be discouraged. Therefore, continuing government prohibition is believed to promote the public interest by reducing both societal loss and morally questionable behavior. The debate on the morality of gambling is beyond the scope of this paper, but regardless of the morality, prohibition and regulation do not stop the behavior. Even the best-intentioned policies may fail to achieve their goals. Prohibition and regulation are

[21] Mitchell, Matthew, 2012.

expensive and ineffective, and indeed often result in adverse, unintended consequences, such as increased crime, violence, and corruption.

With the exception of Nevada, every state has placed limits on the number of casinos. Some have even gone further as to require the casinos be near a body of water, in order to keep all casinos confined to a specified geographic area of their state. Alternative regulatory methods besides licensing casinos have largely been ignored.

One way that cronyism manifests itself is through barriers to entry. Licenses are an example of a barrier to entry that grants quasi-monopoly status on incumbent firms. Granting private firms monopoly privilege encourages them to use resources in a socially wasteful manner, rather than to compete on the basis of price and quality. This is because the government is in control of awarding special privileges that benefit some companies at the expense of others, meaning all companies have an incentive to seek these privileges. Private companies do this through lobbying and rent-seeking, by forming relationships with those who make regulatory decisions. This results in a marketplace of political competition, instead of economic competition. In other words, the focus becomes political favor rather than product quality.

While it is discouraging, it is not surprising to observe examples of this in practice in casino licensing. As predicted by this theory, connections between casino companies, politicians, and lobbyists are often readily observable. Foreseeably, the concentrated interests of organized, powerful, and wealthy firms prevail over those groups whose interests are more diffuse, such as consumers.[22] The commissions that award casino licenses originate with the intent of protecting the public from being overrun by the

[22] Olson, Mancur, 1971.

perceived negative externalities of casinos, but wind up becoming dominated by the interests of the casinos themselves. The case study from Maryland in the next section will exemplify how casino-licensing regulation has led to casino interests being inextricably tied with political motives, indicating the presence of cronyism.

Maryland's History with Casino Legalization

In 2008, Maryland voters approved a constitutional referendum legalizing five privately owned casinos, the first of which eventually opened in September 2010. The referendum specified that the casino market would be regulated through licenses. Halfway between the completion of the first and fifth casinos and after an expensive campaign push fueled by the eventual winner of the license,[23] a 2012 referendum proposing that a sixth license be awarded passed. The process of awarding this sixth license was particularly publicized and contentious in Maryland. While it is certain that elements of the public-choice approach presented in the preceding section apply well to the first five casinos, the narrative of the sixth license, ultimately awarded to MGM Resorts for their National Harbor Casino, offers particularly compelling evidence of cronyism and regulatory capture.

This section will supplement the economic theory presented in the first half of the paper with real-world evidence of cronyism throughout Maryland's experience with legal casinos since 2008. First, I will present the timeline of gambling legalization in the state, exposing the special interests that funded the campaigns for and against further casino expansion in 2012. Next, I will discuss how cronyism was clearly a factor in the manner

[23] See Maryland Campaign Reporting System records.

in which the sixth license was awarded to MGM for their $925 million casino located at National Harbor. Last, I will analyze the performance of Maryland's casino initiative to date, discussing both the successes and deficiencies that have unfolded thus far.

Timeline of Gambling Laws in Maryland

In November 2008, Question 2 passed as a ballot referendum in Maryland with 1,482,295 votes, at 58.7 percent. This provision authorized the state to issue up to five video lottery (i.e., slot machine) licenses with the stated purpose of raising revenue for public education. Additionally, operators awarded with video lottery licenses would be allowed to have table games in their facilities on a limited basis, the amount varying case by case. Upon passage of the provision, the Video Lottery Facility Location Commission was created and placed under the authority of the State Lottery and Gaming Control Agency, which regulates lottery games, including scratch-off tickets and Mega Millions. Governor Martin O'Malley appointed Donald Fry as chairman of this new commission. The seven commission members, who were appointed by the governor and confirmed by the Maryland Senate, were tasked with choosing which counties or cities would receive the five new casinos. Each time a new license was to be awarded, the VLFLC released a Request for Proposals (RFP) with specific instructions on how to apply. Approximately six months after the deadline for proposals, the commission announced the winner. The process of choosing the winner was less than transparent. The Question 2 casino licensing results are detailed in the following chart.

Location	Operator	Name of Casino	Opening Date
Cecil County, MD	Hollywood Casinos	Hollywood Casino Perryville	Sep 2010
Worcester County, MD	Ocean Downs	Casino at Ocean Downs	Jan 2011
Anne Arundel County, MD	Cordish Companies	Maryland Live! Casino	Jun 2012
Allegany County, MD	Lakes Entertainment	Rocky Gap Casino Resort	May 2013
Baltimore City, MD	Caesars Entertainment	Horseshoe Casino	Aug 2014

Table 1. Licensing results following Question 2 referendum

Below is a map of the five casinos in operation as of August 2014 to show how the casinos are distributed within the state of Maryland. While it is impossible to know the exact motives behind how the locations were chosen, some geographical context may be useful. The Rocky Gap Casino caters to the mountainous western part of Maryland. The Hollywood Casino Perryville is the closest casino to the competing Delaware casinos. The Horseshoe Casino is located in Baltimore City, the largest urban area in Maryland. Maryland Live! is near to the capital of the state, Annapolis. And finally, the Casino at Ocean Downs serves the beach region of Maryland.

Figure 1. Map of the casino locations in Maryland. Available at http://gaming.mdlottery.com/about-us/current-locations/

Question 7 Referendum

The possibility of casino expansion was posed to Maryland voters in November 2012. This provision would allow the state to issue a sixth video lottery license for Prince George's County, which surrounds both Virginia and the District of Columbia. The Question 7 referendum passed by a small margin at 51.9 percent with 1,373,886 votes, noticeably less than the vote four years prior.

As with the other five casino licenses, the VLFLC issued an RFP for a Video Lottery Operation License.[24] The RFP was issued in February 2013, and the deadline for proposals was three months later, in May 2013. The 104-page RFP extensively detailed what was required of the potential casino operators in their bid for the license. It required that the casino operator open a commercial casino in Prince George's County, but more

[24] State of Maryland Video Lottery Facility Location Commission, 2013.

specifically that the casino be located within a four-mile radius of the intersection of Bock Road and St. Barnabas Road. This location, known as National Harbor, is very close to the Potomac River, an area where there have been significant targeted efforts for economic development in recent years. This location is relevant to the populations of Northern Virginia, the District of Columbia, and Maryland.

The proposal could allow for up to 3,000 slot machines. The applicants were required to include an initial license fee of three million dollars for each 500 slot machines proposed. The license would be valid for 15 years before a renewal would be required, but operations could commence no earlier than July 1, 2016. Those submitting proposals also had to agree that if awarded the license, they would pay an annual fee of $500 for each table game in operation and $425 for each slot machine.

In December 2013, six months after the deadline for proposals, MGM Resorts won the rights to this sixth license with a proposal to build a casino at National Harbor. This casino is a $925 million project and is set to open in 2016. Their proposal most notably beat out both Penn National Gaming and Greenwood Racing. Penn National wanted to build a Hollywood Casino resort at Rosecroft Raceway, about four miles from National Harbor's location. Greenwood Racing wanted to build a Parx Casino, Hotel, and Spa in nearby Fort Washington, Maryland. It is impossible to trace the counterfactual consequences, but it is possible that if cronyism had not been at play, consumers would have extracted more value out of what could have been, rather than what unfolded as a result of regulatory privilege. This means that upon passage of the initiative, resources were funneled by special interests to accrue license privileges.

Special Interests in the Campaign for Casino Legalization

As mentioned, the inaugural casino initiative, Question 2, passed in Maryland in 2008 by a wider margin than the Question 7 casino expansion referendum in 2012. The 2008 campaign to bring casinos to Maryland was fueled mostly by casino corporations, who outspent the opposition coalition seven to one. The opposition mostly consisted of religious groups who believed casinos would bring increased crime to the state.[25]

Four years later, the Question 7 referendum ended up being the costliest ballot-initiative campaign in Maryland's history.[26] Political advertisements for both sides aired on television and radio, with spending among different groups for and against the ballot measure totaling $95 million, nearly 12 times more than in the 2008 campaign.[27] This was the sixth costliest ballot initiative in nationwide history; the top five were all in California, whose population is more than six times that of Maryland.

Unlike the push to bring casinos to Maryland four years prior, in 2012, casino interests were on both sides of the fight. The opposition to Question 7 was funded primarily by one major casino company, while the proponent coalition was funded primarily by a competing corporation. No longer did all casino companies have an interest in bringing casinos to Maryland, as now casinos were far more prevalent in the general vicinity of the state. A new casino in the DC area would pose significant competition to the existing casinos.

MGM Resorts, the eventual winner of the license, financially backed several of the groups that led the charge in the campaign for Question 7. For example, they

[25] Yglesias, Matthew, 2012.
[26] Wilson, Reid, 2014.
[27] Wilson, Reid, 2014.

contributed $41 million—nearly half of the total contributions for both sides—to the group For Maryland Jobs and Schools, a leading organization in the campaign to pass the casino bill.[28]

Penn National Gaming, which owns the nearby casino in Charles Town, West Virginia, was the primary backer of opposition advertisements. The Charles Town Casino is a mere 90-minute drive from the future location of the National Harbor Casino. A competing casino in Prince George's County would pose a serious threat to Penn National's market share. Penn National spent $42 million on the campaign against the new casino.[29]

Penn National has historically switched sides on casino legalization. Penn National helped finance the 2008 campaign to bring gambling to Maryland. But in 2007 Penn National contributed large sums of money to antigambling measures for Ohio to protect their casino operations in nearby Indiana.

Penn National's changing political endorsements represent its consistent attempts to reap regulatory privilege. Penn National financially backed groups who supported casino initiatives when they believed their company would receive the monopoly privilege that comes with a license. However, whenever they believed that their competitors would receive the license, they funded groups who worked to halt casino initiatives.

Groups that oppose casinos usually rely on moral reasoning.[30] Given that Penn National operates casinos, a moral objection is not the company's likely motivation.

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[28] Maryland Campaign Reporting Information System.
[29] Maryland Campaign Reporting Information System.
[30] Eadington, 1999.

Rather, the way in which the regulatory policies are constructed has presented an incentive for casino interests to rent-seek. This means that, instead of spending money on improving their facilities or otherwise trying to gain market share by competing on price and quality, Penn National used political avenues in an attempt to stifle their competitors. This cost them $42 million in socially unproductive expenses, first in advertising against the gambling expansion, and then in resources devoted to beating their competitors for the privilege in a bid submitted to the regulatory commission — a privilege that, as mentioned, they did not receive. After the license was awarded to MGM, in a process that will be extensively detailed in the next section, Penn National released a statement saying, "We are obviously disappointed. We appreciate all those who stood up against this unseemly back-room deal with National Harbor."[31]

Had the regulatory incentive structure been different, Penn National would not have invested this money in gaining a monopoly privilege and trying to keep competitors from gaining it, but rather invested in making their casinos as attractive as possible to consumers. Penn National's actions are just one example of a nationwide trend.

Cronyism and Maryland's National Harbor Casino

As I have mentioned, even though the process of awarding licenses that started back in 2008 for the VLFLC likely involved lobbying and political favoritism, the allocation of the final, sixth license, in Prince George's County, was particularly contentious. The connections between the politicians and private casino interests and the outcome of MGM's bid are extensive, and they reveal evidence of cronyism at play. As explained

[31] Zeidler, Sue, 2012.

above with the concepts of rent-seeking and regulatory capture, whenever the government grants opportunities for monopoly status, firms will lobby for the rights, and in doing so will expend valuable resources to garner favor. That is exactly what occurred in Maryland. The politically well-connected were able to garner government privilege to obtain the casino licenses. Because the profits up for grabs were significant, it should be no surprise that the battles to get the licenses were intense.

The chairman of the VLFLC, Donald Fry, is a columnist for *Center Maryland*, a news website, where he regularly advocates for more public-private partnerships. Two of the founders of *Center Maryland* are the owners of KO Public Affairs, which represented the interests of MGM in the 2012 ballot-initiative campaign. State campaign-finance records show that KO received a total of more than $400,000 from casino interests to advocate for the passage of Question 7,[32] mainly through funding radio and TV time for advertisements. In the end, the ballot initiative passed, and MGM won that highly valued sixth casino license.

The first of these two founders of *Center Maryland* and owners of KO is Steve Kearney, who was formerly Governor Martin O'Malley's director of policy and communications. The second is Damian O'Doherty, who was a former top aide to Baltimore County Executive Jim Smith and, according to O'Doherty's biography on the KO website, is a "critical link to the O'Malley administration."[33]

The fact that a regular contributor for the *Center Maryland* news website is the chairman for the commission that decides who gets the rights to the casino license should raise an eyebrow. Furthermore, the personal relationships that these three men—Fry,

[32] See Maryland Campaign Reporting Information System.
[33] KO Public Affairs, 2015.

O'Doherty, and Kearney—have with the governor, and with MGM Resorts, is cause for concern.

MGM's partner in the bid for the National Harbor Casino was Peterson Development Companies, LLC. This company owns National Harbor. These two companies were the source of the vast majority of contributions ($3.1 million) to Maryland First NOW, another group advocating for expanded gambling.[34] A subdivision of Peterson, Maryland Workers for National Harbor, shares an address with KO Public Affairs: 111 S. Calvert Street Suite 2820, Baltimore, MD 21202.

The links between the politicians, developers, and lobbyists are undeniable, and therefore MGM being awarded the coveted sixth license is not surprising. The graphic below illustrates the interconnected actors.

[34] See Maryland Campaign Reporting Information System.

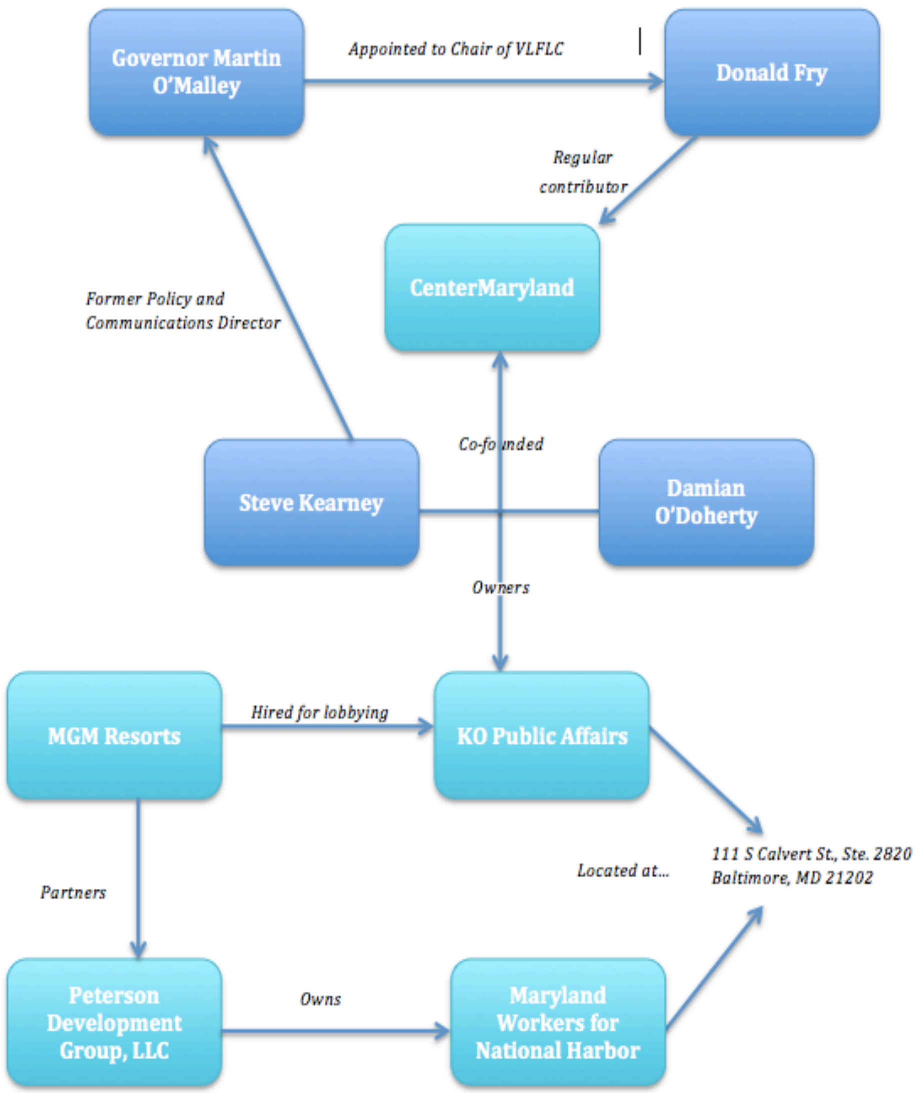

Figure 2. The backdoor process of the sixth casino license in Maryland

The Unintended Consequences of Casino Licensing

The Unfortunate Realities

While allowing casinos in Maryland has generated significant revenue and jobs, there are some disadvantages that directly resulted from the manner in which they were introduced. Had another implementation strategy been used, the same success could have been realized and even surpassed without the unintended consequences of rent-seeking. The process of awarding casino licenses in Maryland, especially the case of MGM Resorts, may very well be an example of regulatory capture. This multimillion-dollar firm had the political capital to garner favor and thus earn enormous profits at the expense of the public and other firms who were not fortunate enough to receive the privilege. However, there was an open application process, so it is possible they had the most viable bid. The problem here is there is no way besides the market process to know.

While the first five casinos have remained in business, this does not mean that they have been established without a hitch. There is evidence of under-demand, hidden costs, and unintended consequences. Under-demand means that there are more casinos in existence than the unhampered market would dictate. Determining the true costs of a policy, including hidden costs, requires employing the tools of economics to evaluate the merits of the policy, not just on the readily observable costs and benefits, but also on the opportunity costs of that policy. When these opportunity costs are not given consideration in analysis, there are adverse unintended consequences.

In July 2012, two years after opening, the Hollywood Casino in Perryville returned between 400 and 500 rented slot machines to the State of Maryland due to declining revenue from idle capital.[35] As previously mentioned, slot machines cost casino operators $425 a month per machine in state fees. The fact that the casino needed to return some of the slots to the state in order to avoid paying the fee for the unused machines could be evidence that the licenses were awarded on political favor rather than market demand. In an unhampered market, errors in predicting demand are inevitable, but

[35] Kilar, Steve, and Michael Dresser, 2012.

the difference is that the mechanism to deal with this error is more efficient when the government is not involved. The adjustment process without intervention is quicker.

The assumption—which justified casino regulation—that lawmakers are enlightened, benevolent actors always promoting the public interest is called into question here. In awarding the Hollywood Company monopoly privilege for Perryville, the commission was unable to ex ante predict the demand that existed in that geographical region, even though they were able to pick political winners and losers. This created a moral hazard for the casino. In an unfettered market, if the Perryville casino were losing money, they would go out of business or be forced to adjust in other ways such as adding new services or reducing the price, but licensure erodes competitive pressures. Because the government awarded them a monopoly privilege, the government has a stake in their success. Even though none of the casinos have been bailed out to date, the fact that Maryland's government has awarded six licenses means that they will continue to implicitly guarantee the success of six different casinos. In effect, the government becomes the partner of the casinos.

Furthermore, the program has been a little more expensive than voters were led to believe. The state provided grants of $1.1 million and $9.6 million in 2010 and 2011, respectively, to fund the start-up costs of slot-machine operations. This fact was not readily advertised; instead it was buried in the 2010 and 2011 Maryland State Lottery Agency Annual Finance Reports.[36] Thus, the taxpayer who voted for casinos on the grounds of improving education also helped foot a hefty bill to even get the program started.

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[36] *Comprehensive Annual Financial Report for the Years Ended June 30, 2011 and 2010.*

Another unpublicized fact is that, as predicted by an independent audit contracted by the State of Maryland to Cummings Associates/Casinonomics Consulting LLC, revenues from traditional lottery products, such as scratch-off tickets and Mega Millions, have declined by about 5 percent in the past several years. There is also nationwide evidence of this phenomenon of legalized casinos drawing some business away from other forms of gambling.[37] This is not to claim that entry of new types of gaming should be prohibited, but to point out that some of the much-touted casino revenues can be attributed to displacements from traditional lotteries.

The Initiative's Success

Overall, casinos are so heavily taxed that, according to the Maryland Gaming Control Agency's website, casino legalization has brought in $2.07 billion to the State of Maryland, with $366.69 million going to the State Education Fund. This number is staggering, and therefore may seem to support the contention that the start-up costs were worth it. This "success" does not imply economic efficiency, however. The rest of the funds are divided among several trust funds: the Horse Racing Purse Dedication Account, the Local Impact Grants Account, the Racetrack Facility Renewal Account, and the Small, Minority, and Women-Owned Businesses Account. In the campaign for casino legalization, improving education was the primary stated goal, and the State Education Fund has received considerable funds from casino revenue over the years, as seen in the table below. The government is getting increased revenues, while the casino operators understand and accept that their businesses face high rates of taxation, much like the

[37] Walker, Douglas M. and John Jackson, 2008.

tobacco industry. It seems to be a mutually beneficial situation. While the casinos would likely prefer a lower tax rate, they more strongly prefer to be allowed to operate at all.

Fiscal Year	Revenue	# of Casinos Open
2011	$12,483,153.20	2
2012	$377,813,542.76	3
2013	$748,676,169.91	4
2014	$931,083,017.41	5
Total	$2,070,055,883.28	

Table 2. Revenue generated from Maryland's casinos for Education Trust Fund. Data Source: Maryland Gaming Website. Available at http://gaming.mdlottery.com/financial-reporting/.

The large sums of money displayed in the table lend support to the claim that casino legalization is a wise policy proposal and a success in Maryland. However, a more open market for the establishment of casinos would generate numbers of this caliber for state revenue, but would simultaneously reduce wasteful and socially unproductive spending. The tax rates could stay, but licenses ought to be eliminated. In a more open marketplace, casinos would be competing with each other to provide the best possible casino experience, rather than competing with each other solely for the opportunity to conduct business in any capacity.

The casino initiative has brought more than 4,000 jobs to the state of Maryland, many of which are full-time and offer benefits. This is beneficial to those 4,000 people; however, in applying the principles of economics, it is crucial to look at both the seen and the unseen effects of a policy. It is no surprise that these firms are profitable and attract employees; they were granted government-monopoly status over other firms that did not obtain licenses. These numbers cannot be considered evidence for policy success. It would be utterly troubling if government-privileged firms could *not* survive. Furthermore, the jobs created by the casinos are not necessarily new jobs; the casinos most likely took jobs from other industries, and this may or may not be beneficial in the long run.

It is impossible to make counterfactual claims, but it is likely that many resources have not been allocated to their highest-valued uses. The gross consumer welfare that these jobs create must be weighed against losses in welfare due to rent-seeking. If casino licenses in Maryland were not restricted to six, it is possible that there would be more jobs and more value created.

Conclusions and Policy Alternatives

While contemporary arguments about prohibition often discuss marijuana and prostitution, gambling is a timely and relevant example. Despite the celebration that ought to accompany the end to outright gambling prohibition in many states across the nation, this is not enough. The regulatory structure ought to be reconsidered. Licensing invites casino interests to become intertwined with the government. Government privilege often begets more privilege, and, according to the theory of regulatory capture, interest groups become the dominant voice in how regulation is imposed.

Instead of a commission of well-connected political actors subject to lobbying influences deciding to whom and for what locations to award casino licenses, the market process should decide who should own casinos, where they should be, and how many casinos should exist. The spontaneous order of the market process is more likely than the political process to employ resources at their highest-valued uses. Moreover, using the market avoids the problems of rent-seeking and cronyism. It is unlikely that in Maryland, an unhampered free market would result in exactly one casino in Cecil County, one in Worcester County, one in Anne Arundel County, one in Allegany County, one in Baltimore City, and one in Prince George's County. Further, it is unlikely that each casino would be run by the current operators. The process of distributing licenses is less than transparent; however, for both Worcester County and Allegany County it is public knowledge that there was only one applicant.[38] This could indicate insufficient demand in that geographic area.

Because the government cannot make the efficient decisions that the market makes, it inevitably ends up picking winners and losers based on political networks. It is not right to blame either those seeking favor or the politicians who distribute favors, because they are just rational actors responding to the incentives they face. The problem is the political institutions that lead to these rent-seeking outcomes. Without institutional change, this socially wasteful behavior will continue. If casinos were subjected to typical marketplace pressures, they would be forced to compete with each other on the basis of price and quality instead of on the grounds of who can garner more favor in the political sphere.

Allowing the free market to decide where the casinos should be, how many of them there should be, and who should operate them is the best policy approach in terms of economic efficiency. However, it is a useful exercise to recognize second-best and more politically palatable alternatives. Highly regulated casinos are preferable to outright bans because of the previously unrealized gains from trade becoming realized. That the

[38] Dresser, Michael, and Cho, Hanah, 2012; Dechter, Gadi, Julie Bykowicz, and Laura Smitherman, 2009.

government has slowly let more casinos enter the market gives hope that eventually the government will begin to take a more hands-off approach. This was seen in the United States with alcohol in the 1920s and 1930s and is currently happening with increasingly lax laws on marijuana. Maryland may follow suit and one day change its policy of restricting entry into the casino market, but still reap the benefits of taxing the casino operators. While there is much reform that could improve the crony capitalism that pervades the current environment, the end to casino prohibition across 23 of the 50 states gives hope that we are on the way to a more open market for casinos.

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